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Supreme Court of the United States

OCTOBER TERM, 1933.

No. 548.

ILLINOIS BELL TELEPHONE COMPANY,

Appellant,

vs.

BENJAMIN F. LINDHEIMER and Others, Constituting The Illinois Commerce Commission of the State of Illinois, *et al.*,

Appellees.

BRIEF FOR APPELLANT ON CROSS-APPEAL.

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Supreme Court of the United States

OCTOBER TERM, 1933.

No. 548.

ILLINOIS BELL TELEPHONE COMPANY,

Appellant,

vs.

BENJAMIN F. LINDHEIMER and Others, Constituting the Illinois Commerce Commission of the State of Illinois; OTTO KERNER, Attorney General of the State of Illinois, and THE CITY OF CHICAGO,

Appellees.

BRIEF FOR CROSS-APPELLANT.

The plaintiff prosecutes this cross-appeal from a decree rendered June 28, 1933, by the United States District Court for the Northern District of Illinois, composed of three judges (Evan A. Evans and Will M. Sparks, Circuit Judges, and James H. Wilkerson, District Judge) as required by Section 266 of the Judicial Code (R. III, 2524), which enjoined the enforcement of an order of the Commerce Commission of the State of Illinois entered August 16, 1923, effective October 1, 1923, prescribing certain rates and charges for plaintiff's telephone service in the City of Chicago, Illinois.

Plaintiff does not seek to reverse the decree entered below, but does seek the correction of certain errors made by the statutory court in determining issues necessary to the decision of the case, in order that:

(1) In any subsequent action between the parties hereto the plea that plaintiff is estopped by the decree and judgment with respect to said matters may not be maintained, and

(2) That plaintiff, as a matter of right, may urge said errors of the lower court in opposition to the appeal of the defendants from said decree (No. 440, to be argued with this appeal) and in support of the lower court's decree, wherein the relief sought by plaintiff was granted.

Prior Opinions in this Cause.

The opinion of the statutory court on the first trial of this cause was filed January 31, 1930, and is reported in *Illinois Bell Telephone Company* v. *Moynihan*, 38 F. (2d) 77 (O.R. I, 178).*

On appeal to this court the cause was remanded with directions to the statutory court to make findings of fact, and to receive such additional evidence as was necessary for that purpose. The opinion of this court was rendered December 1, 1930, and is reported in *Smith* v. *Illinois Bell Telephone Company*, 282 U. S. 133.

The last opinion of the statutory court, pursuant to which the final decree herein appealed from was entered,

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* The letters O.R. are used to designate the record in this court upon the former appeal, *Smith* v. *Illinois Bell Telephone Company*, No. 845, October Term, A. D. 1929, which record has been made a part of the record upon the present appeal but has not been reprinted.

was filed April 29, 1933, and is reported in *Illinois Bell Telephone Company* v. *Gilbert, et al.*, 3 F. Supp. 595 (R. III, 2502).

Jurisdiction.

Appellant, pursuant to Rule 12, paragraph 1, of the rules of this court, has filed a concise statement of the grounds on which it invokes the jurisdiction of this court, and this court has postponed further consideration of the question of jurisdiction until the hearing of this case on its merits.

Statement of the Case.

The Illinois Commerce Commission entered an order on August 16, 1923, effective October 1, 1923, which would have resulted in reducing plaintiff's revenues in the City of Chicago by approximately $1,700,000 annually (O.R. I, 14-45; Findings 28 and 29, R. III, 2520-2521). Before the effective date of this order, the plaintiff commenced an action in the lower court to enjoin its enforcement on the ground that the order was confiscatory (O.R. I, 2 *et seq.*). The statutory court granted a temporary restraining order (O.R. I, 49) and, on December 21, 1923, an interlocutory injunction. The case was tried on its merits in 1929 and a decree was entered by the statutory court on February 28, 1930, permanently enjoining the enforcement of the order as confiscatory (Opinion, O.R. I, 178-198; Final Decree, O.R. I, 199).

The defendants prosecuted an appeal to this court, which remanded the cause with directions to the statutory court to make specific findings for 1923 and subsequent

years with respect to the following issues, and to receive such additional evidence as might be required for that purpose (*Smith* v. *Illinois Bell Telephone Company*, 282 U. S. 133):

(1) The fair value of the plaintiff's property employed in the service of the public in its intrastate business in Chicago, and in that connection to make a separation between the interstate and intrastate property on the basis of actual use.

(2) The fair rate of return which the plaintiff is entitled to earn on such property.

(3) The reduction in revenue which would have resulted if the Commission's rates had been put into effect and the amount of plaintiff's return after giving effect to the reduction.

(4) The cost to the American Telephone and Telegraph Company of rendering services under its license contract to the plaintiff and other Bell Associate Companies, and the reasonable amount which should be allocated in that respect to the operating expenses of the intrastate business of plaintiff.

(5) The proper amount of the annual charges of the plaintiff for depreciation in connection with its intrastate business.

(6) The net earnings of the Western Electric Company in the business done by it with its Bell customers, the reasonableness of such earnings, and the extent to which, if at all, such earnings figure in the estimates upon which the charge of confiscation in this case is based.

Pursuant to the mandate of this court, the statutory court set the case for hearing to receive additional evidence necessary for the determination of the several issues above referred to, and hearings were held commencing on February 23rd (R. I, 1) and ending on July 1st, 1932 (R. II, 2052). By direction of the court, briefs were subsequently filed by the parties, and thereafter the case was argued orally and finally submitted on December 15, 1932 (R. II, 2102-3). It was decided and the court's opinion and findings of fact and conclusions of law were filed April 29, 1933 (R. III, 2502-2522). The findings of fact are thirty-five in number and fully cover all of the matters at issue. As conclusions of law the court held that the telephone rates in suit have at all times been and are now confiscatory of plaintiff's property, and that the interlocutory injunction should be made permanent, and plaintiff be discharged from its bond, and that plaintiff should be released from all obligation to refund to its subscribers the sums of money collected by it pursuant to the terms of the preliminary and interlocutory decrees (R. III, 2525). The final decree granting a permanent injunction was entered on June 28, 1933 (R. III, 2524-6). The defendants have taken an appeal and plaintiff a cross-appeal to this court.

Plaintiff charges error in certain findings of the statutory court, with respect to the valuation of the property, certain items of expenses, and, as to the years 1931 and 1932, the fair rate of return.

The facts, briefly stated, which are material to a consideration of the questions presented by plaintiff's cross-appeal, are as follows:

I.

Valuation.

The statutory court undervalued plaintiff's intrastate property due chiefly to its errors in three important particulars.

1. Actual Existing Depreciation in the Property.

(1) The court found and deducted, as the existing depreciation in the property, 16 per cent. of the reproduction cost new, as determined by the court, for the years 1923 to 1928, inclusive, and 15% for the succeeding years.[1] The evidence established a maximum depreciation of the property of 9% for the years 1923 to 1928, and of 8% thereafter.[2] The resulting undervaluation on this account varied from approximately $9,300,000 in 1923 to $13,800,000 in 1932.

The plaintiff determined the amount of the existing depreciation, first, by careful inspections of the property made by qualified telephone engineers and plant men, who observed and measured the physical condition of the property as compared with like property new, and second, by a survey made by qualified operating officials of the company to find any existing functional depreciation. Thus all elements of actual existing depreciation in the property were taken into account, and the result was expressed in

[1] Finding 6, R. III, 2515.
[2] Exhibit A-22, R. V, 2682; Stipulation, R. III, 2545.

terms of the "per cent. condition" for each class of property.[1]

Defendants did not make any inspection of the property at any time and introduced no evidence going to show the condition of the property. One witness for the defendants, Mr. J. G. Wray, testified on the subject, but only with respect to the approved method of determining the existing depreciation, and his testimony in that respect was in entire accord with that of plaintiff's witnesses.[2]

Upon this record the finding of the court was error of law.

2. Refusal to Accept Western Electric Company Prices in the Years 1930, 1931, and 1932.

The statutory court undervalued the plaintiff's intrastate property for each of the years 1930, 1931 and 1932 by a sum in excess of $4,750,000 by refusing to give effect to reasonable Western Electric Company prices prevailing during such years.

Plaintiff introduced in evidence appraisals of its property for each of the years 1923 to 1931, which were made by William F. Sloan, a competent engineer with broad experience in the construction, operation and appraisal of telephone properties. He testified as to the cost of reproduction new of the plaintiff's property for each of its plant accounts except land and buildings,[3] with respect to which evidence was presented by witnesses with particular qualifications on those matters.[4] The defendants made no appraisal of

[1] R. I, 65-168.
[2] O.R. V, 1729, 1771, 1772.
[3] Testimony of Sloan, R. I, 13-61; R. II, 1297-1330, 1421-4.
[4] Testimony of Renwick, R. I, 62, and Huston, R. I, 63.

the plaintiff's property for any year. Sloan's estimate of reproduction cost new as of June 30, 1923 is less than the Illinois Commission's finding of such reproduction cost new as of that date.[1] Sloan's appraisals for the subsequent years were on bases comparable with his appraisal of June 30, 1923. The court found that Sloan's reproduction costs were substantially accurate for all of the years.

Telephone apparatus and other materials were included in plaintiff's appraisals at the prices paid therefor to the Western Electric Company, which is the manufacturing department of the Bell System, and from which plaintiff purchases all such materials. Such prices to the plaintiff were lower during the entire period involved than the prices at which they could have been purchased from others.[2]

Commencing in 1921 Western's prices to its Bell customers for telephone apparatus were constantly reduced until July 1, 1929.[3] The last reduction was made in anticipation of a large increase in the volume of Western's Bell business in 1930 and subsequent years, which was not realized.[4] Accordingly, in November, 1930 Western restored the prices charged by it prior to such reduction.[5] Western's profits on sales and earnings on investment have been low whether considered for the entire period of years involved or for the particular years in which this price increase was in effect. The statutory court refused to give effect to this price increase and as a result undervalued plaintiff's intra-

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[1] See Opinion on first trial of this cause, *Illinois Bell Telephone Company* v. *Moynihan*, 38 F. (2d) 77-78; also testimony of Turner, O.R. II, 682.

[2] Finding 16, R. III, 2517; O.R. III, 1076 *et seq.*; R. I, 412.

[3] Opinion, R. III, 2508; Defendants' Exhibit X-13-A; R. VI, 3892; R. I, 329-330.

[4] R. I, 450-451.

[5] Defendants' Exhibit X-13-A; R. IV, 3892.

state property by a sum in excess of $4,750,000 for each of the years 1930, 1931 and 1932.*

3. Reductions on Account of General Decline in Property Values.

The statutory court undervalued plaintiff's intrastate property by the sum of more than $14,000,000 in 1931 and more than $23,000,000 in 1932, because it felt "obliged to take notice of the general decline in property values which has accompanied the present period of business stagnation."[1] Plaintiff's appraisals for all the years in controversy were based upon actual prices paid by it to Western Electric Company for materials[2] and upon wages actually paid for its labor,[3] and not upon general commodity prices or enhanced property values. Western's prices to plaintiff were at all times, including the years 1931 and 1932 to which this reduction made by the court applies, below the prices at which plaintiff could have purchased its telephone materials from others.[4] Western's prices to plaintiff were constantly reduced during the years 1923 to 1929,[5] during which time general commodity prices remained substantially unchanged and other manufacturers were either maintaining or increasing their prices.[6] Full consideration was given in the company's appraisal to all conditions which had resulted in the lessening of the value of the company's

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* Finding 19, R. III, 2518; R. II, 1070.

[1] Opinion, R. III, 2505.

[2] R. I, 34.

[3] R. IV, 1301.

[4] Finding 16, R. III, 2517; R. I. 421, 474-5; O.R. III, 1076 *et seq.*

[5] Defendants' Exhibit X-13-A, R. VI, 3892.

[6] Bulletin of United States Bureau of Labor Statistics No. 543, "Wholesale Prices 1930"; R. I, 450.

property in 1931.* These conditions were reflected in the court's valuation for both the years 1931 and 1932 before the reductions here complained of were made.

II.

Expenses.

The statutory court disallowed substantial amounts of three important items of plaintiff's operating expenses as follows:

1. Annual Allowance for Depreciation Expense.

The statutory court, in accordance with the opinion and mandate of this court, determined the amount of the allowance for depreciation expense applicable to the intrastate portion of the property for each year, in its twenty-sixth Finding of Facts.[1] The amount so found by the court for the year 1923 is $4,000,000, and increases with the rapid growth of the property during the period to $7,400,000 in 1931. Plaintiff assigned error to this finding, upon the ground that under the evidence it is entitled to a substantially larger amount in each year, the additional amount ranging from approximately $1,100,000 to $2,100,000 in the several years.[2]

Plaintiff in the regular course of its business carefully computed the amount of this charge and entered it upon its books each month. This was required to be done under the system of accounts prescribed by the Interstate Com-

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* Exhibit A-17, R. IV, 2676-2680; R. I, 63; Exhibit A-18, R. IV, 2680-2681; R. I, 64.

[1] R. III, 2520.

[2] Exhibit A-267, R. V, 3145; Exhibit A-48, R. IV, 2705, 2716, 2723.

merce Commission and the Illinois Commission, the two systems being *identical*.[1] The method prescribed is the straight line method of depreciation accounting[2]. Under this method a separate depreciation rate is determined for each class of the plant, as classified by the commission, which is computed from the expected service life and salvage as determined for each class, and this rate is applied to the cost of the property of each class standing upon the books from month to month. The evidence shows that the service life and salvage, and hence the rate, can be and were determined from adequate data, and by reliable and approved methods.[3]

The charges were recomputed in this case, in conformity with the decision of this court in *United Railways* v. *West*, 280 U. S. 234, upon the basis of the replacement value new of the property in each year, as shown by the evidence and found by the court, by applying the rate for each class to that value. This is the amount that is claimed by the plaintiff and established by the evidence.[4]

2. License Contract Payments.

One of plaintiff's operating expenses was its compensation to the American Telephone & Telegraph Company for services furnished to it. These services were furnished under a formal written contract known as the "License

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[1] O.R. II, 152; O.R. I, 222; O.R. II, 748; R. I, 222, 255.

[2] O.R. IV, 1183-92.

[3] Testimony of Turner, R. I, 750-798, R. II, 1097-1144, 1278-97, 1384-1391, 1426-1433; Testimony of Woodford, R. II, 1177-1204, 1392-1394, 1424; Testimony of Hale, O.R. II, ; Exhibits A-125, A-126, A-127, A-128 and A-129 (R. IV, 2853-2885); A-203 (R. V, 2982), A-263 (R. V, 3141), A-265 (R. V, 3144).

[4] Exhibit A-267, R. V, 3145; R. II, 1397.

Contract". The forms of license contract in effect during the time covered by the trial were those made in 1919 and 1926,[1] but these were amendments and modifications of an agreement entered into between the predecessors of the American Company and the plaintiff as far back as 1881.[2] The original contract and the various amendments have been uniform agreements between the American Company or its predecessor and a great number of operating companies.[3] Under the 1919 amendment the American Company was obligated as follows:

(*a*) To lease licensees all the telephone instruments required.

(*b*) To license the licensee companies under all patents embodied in the said instruments.

(*c*) To give the licensees the right to use all telephonic devices, apparatus, methods and systems presently owned or controlled by the licensor, or thereafter owned or controlled, resulting from the research and experimental work of the licensor, together with licenses under all patents relating thereto.

(*d*) To continuously prosecute experimental and research work in the development of the telephone art.

(*e*) To advise and assist the licensees in all matters pertaining to the efficient, economic and successful conduct of their telephone business.

(*f*) To advise and assist the licensee companies in financing extensions, developments and improvements in their telephone systems, and to aid them in securing funds for new construction and other expenditures.

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[1] Plaintiff's Exhibit 7, O.R. IV, pp. 1196-1217.
[2] O.R. IV, 1196, City's Exhibit 23, O.R. VI, p. 55.
[3] O.R. III, 977-978.

(*g*) To render active assistance to the licensees in the matter of pensions, disability and death benefits for the purpose of maintaining a stable, contented and efficient personnel.

(*h*) To render available for use by the licensee company all the products of the licensor's work of research, investigation and experimentation.

(*i*) To acquire any patent rights held by others necessary to render inventions and discoveries made by the licensor available for the licensee companies.

(*j*) To maintain continuously a sufficient organization of specialists trained for the work of rendering the foregoing services and relieve the licensee companies of attempting to perform the work for themselves.

Plaintiff and the other operating companies, called "Licensee Companies," were obligated to pay to the American Company 4½ per cent. of gross revenues as compensation for the services above described.[1] Prior to 1919 substantially the same general arrangement existed between the parties.[2]

The services rendered by the American Company under the License Contract were not of a kind which constituted a part of the ordinary business of an operating telephone company, nor were they of a kind which the operating companies could perform for themselves. Neither were they services which could have been obtained elsewhere, as the American Company had built up an organization of over 7,000 persons, more than 3,000 of whom were engineers and scientists, and many of whom were specialists who

[1] Plaintiff's Exhibit 7, O.R. IV, p. 1210.
[2] O.R. III, 978, O.R. IV, 1196.

stood at the very top of their various specialties.[1] There was no other organization in the telephone field and no other in any branch of industry in the world, similar to that of the American Company.[2] The services rendered were necessary to the operating companies and to the public as well.

Plaintiff could not possibly have performed for itself the complete service received from the American Company, and such part as it could have performed would have cost it substantially more than the entire payment to the American Company.[3] This was 4½% on gross revenue in 1919 and prior thereto,[4] but was reduced to 4% in 1926.[5]

In 1928 the American Company sold the instruments to the operating companies at a substantial discount and discontinued furnishing and maintaining the instruments. The contract was revised at that time and the payment reduced from 4% to 2%. The next year there was a voluntary reduction to 1½%.[6] All of the reductions from the 4½% rate have been voluntary and without consideration to the American Company except for the discontinuance of the furnishing of the instruments, and all of the said deductions were made after this and other courts had repeatedly sustained the 4½% rate.[7] The costs to the American Company or the offsets against the payments received by it from plaintiff and the other associate companies were: (a) the expenses of the 12 general depart-

[1] O.R. III, p. 976.
[2] R. III, pp. 2192-2194, O.R. III, 54-55.
[3] O.R. III, pp. 1045-1046, 1056.
[4] Plaintiff's Exhibit 7, O.R. IV, p. 1210.
[5] R. II, p. 1165, O.R. IV, 1215.
[6] R. II, 1165.
[7] 259 U. S. 318; 262 U. S. 276, 288; 12 F. (2d) 279, 285 (affd. 276 U. S. 97); 6 F. (2d) 663; 5 F. (2d) 77, 96; 300 Fed. 190, 204; 36 F. (2d) 54, 67.

ments of the American Company, each of which was engaged principally in advising and assisting the operating companies and rendering the services specified in the License Contract; (b) taxes and other expenses incurred in connection with the performance of its obligations thereunder; (c) the furnishing and keeping in repair of the telephone instruments consisting of receiver, transmitter and induction coil.[1] The cost or allowance for this instrument service consisted of the actual out-of-pocket cost of repairs, a fair annual rate for the depreciation of the instruments (7%), and a fair return for the use of the instruments (the same return allowed plaintiff upon the other property used by it in furnishing its service).[2]

The court found the cost of furnishing the License Contract services to plaintiff at the following amounts:[3]

1923	$1,088,195	1928	$1,005,063
1924	1,156,046	1929	1,040,529
1925	1,369,836	1930	1,191,882
1926	1,412,867	1931	1,068,303
1927	1,422,869		

These amounts as found by the court are considerably less in each year than the costs contended for by the plaintiff. This difference for the nine years totals about $2,500,000.[4]

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[1] Plaintiff's Exhibit A-170, R. IV, 2963-2970. Testimony of Dr. F. B. Jewett, R. I. 611-742; Mr. B. Gherardi, R. I. 526-553; Mr. Arthur W. Page, R. I. 745-749; Mr. Charles A. Heiss, R. I. 819-820, 841-848, 881-898, 909-1048; R. II, 1086-1097, 1144-1175; Mr. Edwin F. Carter, R. I. 821-833; Mr. Hugh Blair-Smith, R. I. 849-880; Mr. Charles P. Cooper, R. I. 899-908.

[2] Plaintiff's Exhibit A-162, A-163, R. IV, 2938-2940.

[3] Finding 22, R. III, 2519.

[4] Plaintiff's figures for these amounts are built-up figures based on the computation of some eighteen subdivisions of license contract costs. See Plaintiff's Exhibits A-108, A-117, A-123, A-150, A-170 inclusive, A-200, R. IV, 2840, 2848, 2850, 2914-2953, R. V. 2980; Plaintiff's Assignment or Error 14, R. IX, 4966.

The court below allowed the actual out-of-pocket expenses of maintaining and repairing the instruments, but cut down the annual depreciation expenses from 7% to 6% and the fair return to the American Company claimed on the instruments from 7½% to 6%.[1] Moreover, the court below disallowed all taxes and other expenses incident to the performance of the contract claimed by plaintiff.[2]

The foregoing is a brief explanation of the difference between the amounts claimed by plaintiff as the fair share of the American Company's License Contract costs allocable to plaintiff's intrastate business in the Chicago area and the amounts found therefor by the court below. There was no evidence to support the court's action in trimming the costs or allowances for furnishing the instruments, nor in disallowing taxes and other items.

The fair share of the License Contract costs attributable to the intrastate business of plaintiff found by the court is set forth in its Finding 22.[3] The amounts which the plaintiff actually paid to the American Company for the License Contract services are set forth in Finding 23.[4] The costs of the services rendered to plaintiff *as found* were substantially less than the payments which plaintiff made therefor in the years 1923 to 1927, inclusive, slightly less in 1928, and substantially more in 1929, 1930 and 1931.[5] There was no finding for 1932. According to plaintiff's claim and proof the costs exceeded the payments in four of the nine years[6] and closely approached in two. How-

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[1] Op. R. III, 2509, 2510.
[2] Op. R. III, p. 2511, 2512.
[3] R. III, 2519.
[4] R. III, 2519.
[5] Compare Findings 22 and 23, R. III, 2519.
[6] Plaintiff's Proposed Finding 51, R. III, 2417, Plaintiff's Exhs. A-170, A-201, R. IV, 2953; R. V. 2980; Court's Finding 23, R. III, 2519.

ever, although the statutory court found that the License Contract was made in good faith and was fair to plaintiff, it has disregarded the amounts of payment made thereunder and has allowed for operating expenses in connection with the License Contract, only the costs found in Finding 22 for the years 1923-28, both inclusive, and the payments found in Finding 23 for the years 1929, 1930 and 1931.[1] Thus the court has taken cost or payment, whichever was lower, in determining the amount to be allowed to plaintiff in its operating expenses with respect to the License Contract.

Plaintiff contends that, on the evidence, and on the findings the License Contract should have been sustained, and the full amounts paid thereunder should have been allowed as operating expenses. Plaintiff contends further that the costs found in Finding No. 22 were less than the true costs, and further, that in any event the allowance for operating expenses must be determined upon a consistent basis and must be costs in all years or payments in all years, and not whichever of the two is lower in each particular years.[2]

3. Maintenance Expense.

The court deducted from the operating expenses of the plaintiff $67,167 for the last two months of 1930, $332,470 for 1931, and an equal amount for 1932. These deductions were made because of the court's refusal to give effect to the 10 per cent increase in Western's prices in November, 1930, which we have discussed *supra* at p. 7, and result from a reduction of such 10 per cent from the prices charged by Western on purchases attributable to maintenance and other expense accounts.

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[1] Finding 25, R. III, 2520.

[2] Plaintiff's Assignments of Error 9 (b); 14, 15, R. IX, 4965-4966.

III.

Fair Rate of Return.

Plaintiff's business was neither free from hazard nor so considered by the investing public. It was more hazardous than a gas or electric business and required a higher rate of return to attract capital.[1]

The fair rate of return to plaintiff considered separately and alone or as a member of the Bell System was in each case at least the following percentages in the following years:

1923, 8 per cent.; 1924, 8 per cent.; 1925, 8 per cent.; 1926, 8 per cent.; 1927, 8 per cent.; 1928, 7 per cent.; 1929, 7 per cent.; 1930, 7 per cent.; 1931, 7 per cent. until the latter part of the year and then 8 per cent.[2]

The above facts were shown by highly qualified experts called by plaintiff who testified both to the ultimate fact of the percentage rate and also to the subsidiary facts supporting that ultimate fact.[3]

Defendants called no witnesses who testified to any fair rate of return but introduced tabulations showing prices at which plaintiff and the Bell System had obtained moneys in the past.[4] The prices paid properly interpreted support

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[1] R. I, 157, 158.
[2] R. I, 159, 160, 213.
[3] Testimony of Hoyt, R. I, 151-160, 187-217; Testimony of Brown, R. II, 1153.
[4] Defendants' Exhs. X-227 to X-262, inc.; R. VII, 4190-4341.

plaintiff's contention.[1] In this connection the fact that plaintiff and the American Company were greatly undercapitalized is an important consideration.[2]

The court found the fair rate of return at the following amounts for the following years: 1923 to 1927, inclusive, 7½%; 1928, 1929, 1930, 7%; 1931, 6½%; 1932, 5½%.[3]

Plaintiff has assigned error to the findings above with respect to the years 1931 and 1932 only,[4] although the findings for the preceding years are less than those shown by the evidence.

The court below found a lower rate of return in 1931 and 1932 than in the preceding years by taking judicial notice of the falling off in corporate earnings.[5] It failed, however, to take judicial notice of the greater falling off in the price of corporate securities which kept the rate of return to investors as high or higher in 1931 and 1932 than in the years previous thereto.

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[1] Exhibit X-343, R. VIII, 4476.

[2] Defendants' Dep. Exhibits 44 to 50, inclusive, R. V. 3306, 3312-3314, 3319-3320, 3324-3325, 3332-3333, 3339-3340, 3347-3350.

[3] Finding 32, R. III, 2521.

[4] Plaintiff's Assignment of Error 21, R. IX, 4968.

[5] Opinion, R. III, 2514.

SPECIFICATION OF THE ASSIGNED ERRORS HEREIN URGED.

I.

Valuation.

The court undervalued the property of the plaintiff by substantial amounts in each of the years involved in the case. Such undervaluation is in large part the result of the court's errors in the following respects:

A. The court undervalued the property by deducting excessive amounts for actual existing depreciation, such excess ranging from $9,300,000, to $13,800,000 in the several years.

Assignment of Errors 1 (a), 2, 4, 5, 7 (R. IX, 4962).

B. The court undervalued the property in each of the years 1930, 1931 and 1932 to the extent of more than $4,750,000 by refusing to give effect to reasonable Western Electric Company prices prevailing in those years.

Assignment of Errors 1 to 6 inclusive (R. IX, 4962).

C. The court undervalued the property by more than $14,000,000 in 1931 and more than $23,000,000 in 1932 by erroneously giving effect to a general decline in property values in those years.

Assignment of Errors 1 to 6 inclusive (R. IX, 4962).

II.

Expenses.

The court disallowed substantial amounts of the plaintiff's reasonable and proper operating expenses in each of the years involved in the case, specifications whereof are as follows:

A. The allowance for the annual charge for depreciation expense, as found by the court, is less in each year than the reasonable and proper amount shown by the evidence, such deficiency in the allowance in the several years ranging from approximately $1,100,000 to $2,100,000.

Assignments of Error 9 (a), 11, 16, 17, 18, 19 and 20 (R. IX, 4962).

B. The court erred in its findings by disallowing portions of the annual payment made by plaintiff to the American Telephone and Telegraph Company for services rendered pursuant to a contract between the two companies, known as the license contract, the amounts erroneously disallowed ranging from approximately $200,000 to $630,000 in the several years respectively.

Assignments of Error 9 (b), 14, 15, 17, 18, 19 and 20 (R. IX, 4962).

C. The court erred in deducting from the plaintiff's reasonable operating expenses subsequent to November 1, 1930, 10% of the prices charged by the Western Electric Company on purchases made by plaintiff attributable to maintenance and other expense accounts, such deductions amounting to more than $65,000 for the last two months of 1930 and more than $330,000 for each of the years 1931 and 1932.

Assignments of Error 9 (c), 13, 17, 18, 19 and 20 (R. IX, 4962).

III.

Fair Rate of Return.

The court erred in finding that the fair rate of return was 6½% for the year 1931 and 5½% for the year 1932.

Assignment of Error 21 (R. IX, 4962).

ARGUMENT.

Plaintiff charges error in certain findings of the statutory court, with respect to (1) the valuation of the property, (2) certain items of expense, and (3) as to the years 1931 and 1932, the fair rate of return.

I.

Valuation.

The court undervalued plaintiff's intrastate property by substantial amounts in each of the years involved in the case, due chiefly to its errors in three important particulars now to be discussed.

1. Actual existing depreciation in the property.

The statutory court undervalued the property by deducting excessive amounts for actual existing depreciation.

(Assignments of Error, 1 (a), 2, 4, 5, 7, R. IX, 4962.)

The court made a definite finding of the amount to be deducted, which is its sixth finding of fact, as follows:

> "6. The fair rate of depreciation to be applied to the reproduction cost new in determining the valuations for rate-making purposes, is sixteen per cent. for the years 1923 to 1928, inclusive, and fifteen per cent. for the succeeding years" (R. III, 2515-6).

In its opinion, the court says:

> "In considering the reproduction cost new as an element in arriving at value, it is necessary to deduct the actual existing depreciation in the property as compared with the new one in order to find the value of the physical elements commonly referred to as the structural value of the property.
>
> "A consideration of the evidence on this subject, including that of the witnesses who inspected the property, has led to the conclusion that the fair rate of depreciation is sixteen per cent. for the years 1923 to 1928, inclusive, and fifteen per cent. for the succeeding years" (R. III, 2505).

The evidence shows a maximum depreciation of 9% for the years 1923 to 1928 and of 8% thereafter.

The excessive deduction by the court resulted in the undervaluation of the property in the several years by the

approximate amounts shown in column 5 of the subjoined table:

	Reproduction Cost Intrastate Property Excluding Land and Right of Way		Deduction for Existing Depreciation		
	Amount at December 31 from Exhibit A-41 "Intrastate Total" (1)	Average Amount for Calendar Year (Computed from Col. 1) (2)	As Percentage of Reproduction Cost Court's Finding (3)	Company's Evidence (4)	Court's Finding in Excess of Company's Evidence (in Round Figures) Col. 2 Multiplied by Col. 3 Minus Col. 4 (5)
1923	$139,654,758	$133,244,605	16%	9%	$ 9,300,000
1924	146,223,565	142,939,162	16%	9%	10,000,000
1925	159,884,262	153,053,914	16%	9%	10,700,000
1926	165,032,055	162,458,159	16%	9%	11,300,000
1927	176,290,322	170,661,189	16%	9%	11,900,000
1928	184,618,758	180,454,540	16%	9%	12,600,000
1929	197,887,923	191,253,341	15%	8%	13,300,000
1930	198,679,303*	198,283,613	15%	8%	13,800,000
1931	197,032,239*	197,855,771	15%	8%	13,800,000
1932	.....	197,032,239	15%	8%	13,800,000

* These amounts for 1930 and 1931 have been reduced by $5,674,723 and $5,620,356, respectively, below those stated in Exhibit A-41, on account of the Court's adjustment of Western Electric Company prices in those years (Pages 36 to 44, *infra*).

The statutory court's statement of the applicable rule of law, in the first paragraph above quoted from its opinion, is substantially a paraphrase of what this court said in its opinion in the Minnesota Rate Cases, as follows:

> "It is also to be noted that the depreciation in question is * * * *the actual existing depreciation in the plant as compared with the new one.* * * * And when an estimate of value is made on the basis of reproduction new, the extent of the existing depreciation should be shown and deducted." Minnesota Rate Cases, 230 U. S. 352, 457. (Emphasis ours.)

The company determined the amount of the depreciation by making an inspection of the property, which took

into account all elements of actual existing depreciation. Such depreciation is not a matter of formula or theory. The books of account or other records of the company do not record such depreciation, or purport to do so, and in the nature of the case they could not. *McCardle* v. *Indianapolis Water Company,* 272 U. S. 400, 416, and cases there cited.

The only witness for the defendants who testified on the subject was J. G. Wray, one of the valuation engineers who has represented the city throughout the case. His testimony was given at the first trial; the defendants offered no evidence on the subject at the second trial. Mr. Wray did not make an inspection of the property, and he gave no testimony as to its condition or the amount of the existing depreciation. Such testimony as he did give was confined to the method of determining the amount of such depreciation and in that he was in substantial accord with the witnesses for the plaintiff.

On direct examination at the first trial, Mr. Wray testified, in part, as follows:

> "In addition to the general examination of the property as a whole, we examine portions of it very closely and examine enough of the different classes of property to establish averages which are representative of the property as a whole."
>
> . . . . . .
>
> "When we have determined the per cent. condition of each item of property, then in determining the value of the property we apply the per cent. condition to the reproduction cost, and arrive at a figure which is known as the 'reproduction cost in present condition.' That I think is the most accurate characterization of what we do. I think it is the

most exact method that can be used at all * * *" (O.R. V, 1729).

On cross-examination he further testified:

"In other words, per cent. condition is determined by inspection" (O.R. V, 1771).

"I believe in inspecting a property and ascertaining its condition without any relation to the depreciation rate, the age of the property or the amount in the depreciation reserve" (O.R. V, 1772).

There are certain broad considerations, shown by the record, which have an important bearing upon the condition of the property and which we think should be brought to the attention of the court in advance of a discussion of the evidence directly pertaining to the inspection of the property.

1. The Commission found that the property was "in at least 90 per cent. condition." Commission Finding No. 4 (O.R. I, 43). The only testimony that was before the Commission on this subject so far as its order discloses was that of the company's witnesses, who testified to a condition of 92 per cent. at that time. Referring to this testimony, the Commission says:

"In other words, the property has depreciated some 8% as testified to by the company's witnesses, which when expressed in terms of the original cost of the depreciable property, would mean that there has been a lessening of worth to the extent of $6,425,000" (O.R. I, 27).

2. The property in Chicago is a modern Bell System plant (R. I, 73). There is an abundance of uncontra-

dicted evidence scattered throughout the record to prove this.

In its opinion, the trial court says:

> "It (the Chicago property) is well planned, efficiently engineered and properly constructed * * *. It is well adapted to the needs of Chicago and through years of operations has become fully efficient and serviceable to that community * * *. The plaintiff has been efficiently and economically operated and has had a high standard of maintenance * * *. Plaintiff has engineered and planned its property so that as additions are required to meet the future needs of the community they may be made efficiently and economically" (R. III, 2506).

3. The Chicago property was maintained at a high and even standard of maintenance throughout the years involved, and was kept in excellent condition at all times (R. I, 73, 139-40, 132, 115-16, 145-6). Through this process of current maintenance, worn, damaged or otherwise defective parts were being constantly removed before their impairment affected the telephone service. Other current repairs, not involving the substitution of new piece parts for old, had a similar effect (R. I, 98, 139-40, 132, 116).

4. The factors of "inadequacy" and "obsolescence" were continuously anticipated by the company, so that the telephone service might not be impaired, and no depreciation of that character was ever present in the plant, except to the slight extent that obsolete items of plant were found, as hereinafter stated on page 32. Such items were depreciated practically 100 per cent. (R. I, 72-3, 162-3, 140). The property was at all times capable of giving adequate

telephone service abreast of the art, and there was no functional depreciation at any time, other than that due to the slight amount of obsolescence just noted (R. I, 73).

5. New plant was being installed continuously in very large amounts during this period. Such plant, undepreciated, tended to raise the average per cent. condition and to keep it at a high level.

The business expanded with great rapidity. The number of telephones in Chicago increased from 690,000 at the end of 1923 to 940,000 at the end of 1931, and was 987,000 at the peak in 1929. (The exact figures are shown in Plaintiff's Ex. A-56, R. IV, 2775.) In the period 1923 to 1931 the cost of the plant as shown by the books rose from $85,000,000 to $195,000,000, so that during a term of nine years a greater amount of plant was added new to the property than was in service at the beginning of the term. In addition, replacements of plant were very heavy; Exhibit A-57 (R. IV, 2776-7) shows that from 1923 to 1931 used plant taken out of service amounted in the aggregate to $79,000,000.[1] Even excluding retirements of short-lived plant at subscribers' stations replaced more than once during the nine years, the retirements amounted to approximately $30,000,000.[1] The new construction was spread over the years in a fairly even ratio to the plant then in service (Exhibit A-57, R. IV, 2776-7). While the amount of the retirements varied more widely from year to year than did the additions, as the exhibit referred to shows, their distribution over the period

[1] Exhibit A-57 (R. IV, 2776-7) gives the exact figures by years. These figures, it is to be noted, relate only to the capital accounts and do not include new parts installed to replace old parts, in the course of current maintenance, in units of property not retired. Such substitutions or "repairs" are in addition to these amounts.

was still such that they also tended to maintain the per cent. condition at a constant level.

The Inspection of the Property.

The defendants did not make any inspection of the property at any time, and the testimony of plaintiff's witnesses now discussed, both that at the first trial and the second trial, is uncontradicted.

First Trial. S. A. Rhodes was the company's witness on this subject at the first trial (O.R. II, 699-709). He had made an inspection of the property during the months of December and January in 1921-22 in connection with the Commission's investigation. He had been Chief Engineer and had become thoroughly familiar with the plant in the regular course of his employment over a period of 35 years. He made a second inspection of the plant in the summer of 1923 (O.R. II, 699-700). He testified that the plant was in at least 90 per cent. condition. His findings as to the amount of existing depreciation are stated for each class of plant separately, being stated in terms of per cent. condition as compared with new, as of June 30, 1923, in Plaintiff's Exhibit 2 of the previous record (O.R. IV, 1182). He understood that anything that was obsolete or inadequate was to be depreciated accordingly, and that otherwise the depreciation was to be measured by comparing the plant as he found it with the same things new. The only item of plant that he found obsolete was certain paper conduit, of which there are about 190 duct miles out of a total of some 4,500 duct miles. This paper conduit had been placed in the years 1901-2 and was still in use and in the main giving satisfactory service, but there was some trouble with it and it was of a type no longer considered

proper for new installation or replacement. He depreciated this conduit 80 per cent., that is, he gave it a per cent. condition of 20 per cent. He found that no part of the plant was inadequate (O.R. II, 699-709).

Second Trial. In preparation for the second trial a most thorough and careful inspection of the property was made in the early part of 1931, and is fully set forth in the record.

> Frank Redmund, R. I, 65-74, 160-166.
> Frank P. Hyatt, R. I, 75-111, 133-142, 166-168.
> E. T. Young, R. I, 111-116, 142-148.
> Maynard H. Riley, R. I, 116-132, 148-151, 168.

The completeness and accuracy of this inspection of the property are conceded by the defendants. A stipulation to that effect has been entered of record, at pages 2595-6, Vol. III, of the present record, as follows:

> "7. It is agreed that, for all issues arising on appeal, Exhibits A-19 to A-21, inclusive, A-23 to A-38, inclusive, and A-210, omitted from the record in the Supreme Court, showed a very thorough inspection of Appellee's property in its Chicago Area in minute detail as of December 31, 1930, the summary sheet of which, Exhibit A-2,* is included, and accurately recorded what the inspection purported to show, that is, the per cent. condition of the property as that term was used and understood by Appellee's witnesses. No question will be raised by Appellants in the Supreme Court because of the omission of said exhibits from the record."

Exhibit A-22, bearing the heading "Per Cent. Condition of Plant on December 31st of each Year from 1923 to

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* This is a misprint and should be A-22.

1930—Chicago'' is in the record (R. IV, 2682), where the facts are summarized. This exhibit shows the per cent. condition separately for each class of plant for each of the years 1923-30. These percentages run all the way from a low of 77 per cent. for pole lines to a high of 99 per cent. for underground conduit and underground cable. The weighted total or overall condition is 91 per cent. (or 9 per cent. depreciation) for each of the years 1923-1928, and 92 per cent. for the subsequent years. The witnesses testified that the condition for the year 1931 and at the time of the trial in 1932 was, to their knowledge and in their judgment, not less than that found at the time of the inspection, or 92 per cent. (R. I, 73, 110, 116, 132).

In view of the above stipulation it is unnecessary for us to review the testimony except to the extent necessary to show what is meant by the term "per cent. condition of the property," as used and understood by the witnesses. This same term, it will be recalled, has been used throughout the entire history of the case. The Commission found that the property was "in at least 90% condition" (*supra*, p. 26). Defendants' valuation engineer, J. G. Wray, employed the same term (*supra*, pp. 25-26).

The term does not connote or have any relation to what is known as "deferred maintenance." The evidence is uncontradicted that the property was at all times fully maintained, and the Court found that it was "fully efficient" and that it has had "a high standard of maintenance" (*supra*, p. 27).

All existing depreciation, both physical and functional, was found, was reduced to a percentage, and subtracted from 100 per cent. The remainder is "per cent condition."

The manner in which the depreciation was determined is as follows:

First, an examination of the physical things was made by the field forces for the purpose of finding every kind of physical impairment. Condition new was assumed to be free from defects or impairment of any kind, that is, perfect or 100% condition, and the thing as it stood in actual use in the plant was compared with the same thing new (R. I, 162, 135, 147, 150-1).

Second, the plant was surveyed to determine whether or not any of the parts were inadequate or obsolete and any such depreciation was also deducted. It is necessary in reading the testimony of the witnesses to distinguish this from the physical examination made by the field forces and referred to in the preceding paragraph. This survey was the primary responsibility of the men who headed the organization which was set up by the company to make this depreciation study. They were high operating officials of the company in the Chicago area, possessing exceptional qualifications for this work. Throughout the period involved in this case it had been their duty to know the plant intimately, and they had, moreover, actively participated in the field inspection.[1]

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[1] Each of these witnesses testified that no part of the plant was inadequate at any time. A few obsolete items were found which in the aggregate, while more than negligible, are of slight importance in relation to the whole. Such items were depreciated practically 100% (R. I, 72-73, 162-3, 140). The specific items of obsolete plant found are the following:

1. Certain call circuit keys in switchboards, depreciated 100%.
2. Certain carrier equipment and apparatus at Morrell Park Station, depreciated 100%.
3. A certain type of teletypewriter, depreciated 100%.
4. One million feet of paper conduit, depreciated 95% (R. I, 72-73).

The witnesses did not concern themselves with future inadequacy or obsolescence. The fact that a cable, for example, now fully adequate to the demands of the service (which includes a reasonable margin of spare capacity, R. I, 140), might become too small and hence inadequate at some time in the future, was not for that reason marked down in per cent. condition.

The following testimony of Mr. Redmund on cross-examination (R. I, 163) fairly summarizes the testimony upon this point:

> "I considered physical condition, inadequacy and obsolescence, as I have explained those terms. I did not take into consideration any retirements that may occur in the future due to new inventions or discoveries. That was not part of my work. Nor did I take into consideration wear and tear in the future, or something that might occur subsequent to the date of the inspection, but which has not yet happened. I took the condition as I found it at that time. I did not speculate on what might happen in the future, nor did I consider at all the retirements of property that might occur subsequent to the date of the inspection because of physical changes, or because of future public requirements, or future changes in the public demand, or because of future losses that might occur through storms, and so forth."

The record shows without dispute that the company during all the period of this suit furnished fully adequate telephone service to the people of Chicago in the second largest telephone exchange in the world, second only to the New York City exchange. The service measured up to the standards of the telephone art at all times. There is no evidence of inefficiency. The plant capable of giving

such service was not functionally deficient, in any practical sense. This is not to say that parts of the plant do not from time to time become inadequate or obsolete, but that the company continuously anticipates and forestalls inadequacy and obsolescence. Before a thing becomes inadequate or obsolete it is removed from the plant, written out of the accounts, and thereafter does not appear in the appraised value of the property upon which the company claims the right to earn a fair return.

There remains for consideration the condition of the property in the intervening years between the 1923 and the 1931 inspections. In this connection the general facts set forth herein, *supra*, pages 26 to 28, are important. Also in this connection it is to be borne in mind that Mr. Redmund, who was in general charge of the inspection in 1931, and Messrs. Hyatt, Young and Riley, who were, respectively, in immediate charge of the inspection of inside plant, buildings, and outside plant, were in intimate daily contact with the property throughout all these years (R. I, 73-74, 109-111, 115-116, 132, 145). They had been in charge of its construction, maintenance and operation, and were thoroughly conversant with it.

As appears from Exhibit A-22 (R. IV, 2682) the percentage of depreciation in the various classes of plant did not vary materially during the period, with the exception of three classes, namely, central office equipment, private branch exchanges and booths and special fittings. In the case of central office equipment, there were large installations of new equipment in 1929 which had the effect of raising the per cent. condition for the entire class from 92 per cent. for prior years to 93 per cent. for 1929 and subsequent years. In the case of private branch exchanges, the per

cent. condition improved gradually from 88 per cent. in 1923 to 94 per cent. in 1930 due to the unusually large proportion of new installations and correspondingly large retirements of the old. In the case of booths and special fittings, the per cent. condition gradually improved from 78 per cent. in 1923 to 85 per cent. at the end of the period, in this case also because of abnormally large changes of booths at pay stations. These are the changes which in the main account for the fact that the overall condition of the plant rose from 91 per cent. for the years 1923-1928 to 92 per cent. thereafter (R. I, 74, 109-11, 115-16, 132, 141, 145-147).

Each one of these witnesses testified that by reason of his day-by-day familiarity with the plant during all of these years, of having had charge of the changes in it, having been responsible for its proper condition and functioning at all times, each one in his own department of the service, and having made the complete inspection herein shown, he was able to arrive at a fair judgment as to its condition in those years. The testimony of the witnesses with respect to the intervening years appears at the following places in the Record upon this appeal: Vol. I: Redmund, direct, page 74, cross, 160-62, 164; Hyatt, direct, 109-10, cross, 138-9; Young, direct, 115, cross, 145-47; Riley, direct, 132.

The matter is one that lies peculiarly within the province of technically trained men. There is nothing inherently unreasonable or improbable in what they have said. The trial staff of the defendants was manned with telephone engineers, some of whom testified upon various phases of the case, but no one of them challenged the testimony of these witnesses with respect to this matter.

Plaintiff's evidence is clear, definite, and convincing. It shows every element of actual existing depreciation in the property. There is no evidence to the contrary. The court can form no judgment as to a matter of this character except as it is based upon the evidence. The court is not at liberty to refuse to accept such evidence upon such an issue. It is clear from the court's opinion and findings that the error was carried into the valuation. Upon this record, the court's action was error of law.

We respectfully submit that the trial court has undervalued the property of the plaintiff by the amount of the excessive deduction for existing depreciation shown in the table, *supra*, p. 24, and that the error should be corrected.

2. The statutory court undervalued the intrastate property of plaintiff for each of the years 1930, 1931 and 1932 to the extent of more than $4,750,000 by refusing to give effect to reasonable Western Electric prices prevailing in those years (Assignments of Error 1-6 inclusive).

In remanding this cause to the statutory court for the purpose of making findings and receiving the necessary additional evidence for that purpose, this court said, in discussing the Western Electric Company relationship:

> "The point of the appellants' contention is that the Western Electric Company, through the organization and control of the American Company, occupied a special position with particular advantages in relation to the manufacture and sale of equipment to the licensees of the Bell system, including the Illinois Company, that is, that it was virtually the manufacturing department for that system, and

> the question is as to the net earnings of the Western Electric Company realized in that department and the extent to which, if at all, such profit figures in the estimates upon which the charge of confiscation is predicated. We think there should be findings upon this point" (283 U. S. 133, 153).

Plaintiff's estimates of reproduction costs were based upon prices paid by it to Western, from which it purchased substantially all of its telephone apparatus and other plant materials. Western increased its prices for telephone apparatus 10 per cent in November, 1930 (Finding 20, R. III, 2519). This advance substantially restored the price level prevailing before Western's price reduction in 1929.*

The court eliminated this price increase in arriving at the fair value of plaintiff's property for the years 1930, 1931 and 1932, and as a result undervalued plaintiff's intrastate property for each of said years by a sum in excess of $4,750,000. The basis on which this figure is arrived at is shown in the margin.†

The court's action in eliminating this price increase cannot be justified, as we shall show.

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* The price level of telephone apparatus at the end of 1928 was 64 per cent. of the price level of December 31, 1920. After the price increase of 1930 it was 64.4 per cent. (Exhibit X-13A, R. VI, 3892).

† Substantially 50% of the cost to reproduce new plaintiff's property in any given year consists of telephone apparatus and materials purchased from Western (R. II, 1314). 59% of plaintiff's purchases from Western during the period 1923-1931 consisted of telephone apparatus (R. I, 335). Therefore 29½% of plaintiff's reproduction cost new of the structural property consists of telephone apparatus.

The figures above are arrived at by relating the 10% reduction in Western's prices made in November 1930 and rejected by the court to that portion of plaintiff's reproduction cost new represented by telephone apparatus and depreciating the same in accordance with the court's findings.

Whenever a reasonable profit could be made by Western at lower prices than then prevailing, its uniform policy was to make reductions accordingly. This policy was consistently pursued, even in years when other manufacturers were maintaining or increasing their prices (R. I, 450; R. VIII, 4557). In conformity with this policy substantial reductions were made from time to time in Western's prices to its Bell customers beginning in 1921 and ending on July 1, 1929. The price level of telephone apparatus at the end of 1929 was only 58.3 per cent. of what it had been on December 31, 1920.*

The last reduction referred to was made because Western anticipated a large increase in the volume of its Bell business. Such anticipated increase was not realized but, on the contrary, a substantial decline began in the last half of 1930 and continued during the subsequent years. Before the end of 1930, it became clear that the price reduction made in 1929 was not justified (R. I, 450-451).

The action of the statutory court in refusing to give effect to the price increase made by Western in November, 1930, could only have been proper:

First, if the result of such price increase was to require plaintiff to pay more to Western for its telephone materials than it could have purchased them for from others; or

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* The annual changes in the price level of Western's telephone apparatus to plaintiff were as follows: 1921, — 1.7 per cent.; 1922, — 10.7 per cent.; 1923, + 0.2 per cent.; 1924, — 5.6 per cent.; 1925, — 1.1 per cent.; 1926, — 8.7 per cent.; 1927, — 4.9 per cent.; 1928, — 10.3 per cent.; 1929, — 8.6 per cent. (Opinion, R. III, 2508; Defendants' Exhibit X-13A, R. VI, 3892; R. I, 329-330).

Second, if such price increase resulted in Western earning unreasonable profits.

The evidence in the record and, indeed, the court's own findings conclusively negative the existence of either of these justifiable bases for rejecting such price increase.

As to the first test, the court found upon uncontradicted testimony that Western's prices to plaintiff and its other Bell customers had been lower, during the entire period 1916 to 1932, inclusive, than prices charged by other manufacturers for comparable materials and lower than the prices charged by Western to independent telephone companies and others for the same materials (Finding 16, R. III, 2517; R. I, 421, 574-5; O. R. III, 1076, *et seq.*). It was, therefore, impossible for the court to refuse to give effect to this price increase on the ground that Western's prices were thereby increased above prices of other manufacturers for the same or comparable materials.

As to the second test, the court found that Western's earnings were reasonable at all times prior to the price increase made in November, 1930. It specifically found Western's earnings, including the amount of the price increase, to be only 4.6 per cent and 4.2 per cent on Western's investment in its Bell business for the years 1930 and 1931, respectively, and that it would sustain a loss in 1932 (Finding 19, R. III, 2518). It was shown that this loss would be more than $6,400,000 (R. II, 1070-1). Western's earnings were thus shown to have been reasonable whether considered over a period of years or for the particular years in which the increase was effective. The court's action in rejecting this price increase cannot, therefore, be sustained on the basis that Western's earnings in its Bell business were at any time unreasonable.

Apparently recognizing that such price increase could not be rejected on the basis of the two controlling tests just discussed, the court in its opinion, in seeking to justify its action, says that "In view of the general price trend during the years 1931 and 1932, this advance in price should be eliminated from the computations upon which the charge of confiscation is determined * * *" (R. III, 2508). When consideration is given to Western's consistent policy of price reductions during a period of business expansion, when other manufacturers were maintaining or increasing their prices, and to the fact that Western's prices during the entire period involved were lower than prices at which plaintiff could have purchased comparable materials from others, it is obvious that general price trends cannot be made the basis for a rejection of reasonable Western prices in 1930, 1931 and 1932.*

The action of the statutory court in refusing to give effect to such price increase in arrixing at the fair value of plaintiff's property for the years 1930, 1931 and 1932 cannot be sustained on any proper basis. The following facts found by the statutory court and fully sustained by the evidence further emphasize the reasonableness of Western's prices and earnings:

FIRST: Commencing in 1921, Western made substantial reductions in the prices charged by it for telephone

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* In connection with further reductions in the valuation of plaintiff's intrastate property made by the statutory court on account of general decline in property values it is shown under Expenses, *infra*, at p. 45, that such a decline cannot fairly be applied to the reproduction cost estimates of the plaintiff which have never been based upon general commodity prices or enhanced property values. The reasons there stated apply with equal force here.

apparatus. These reductions from 1923 to 1929 amounted to about 35 per cent. (Opinion, R. III, 2508; Defendants' Exhibit 13A, R. VI, 3892). During the period last referred to, general commodity prices which this court will notice judicially remained substantially unchanged (Bulletin of the United States Bureau of Labor Statistics No. 543: "Wholesale Prices 1930").

SECOND: Western's profits on sales to its Bell customers for the period 1916 to 1932 were 4.5 per cent. and for the period 1923 to 1932 4.7 per cent. (Finding 18, R. III, 2518). Not only were these profits on sales low, but they were less than one-half the profit on sales made by other large comparable manufacturing industries (Opinion, R. III, 2508; Exhibits A-86, R. IV, 2824 and A-87, R. IV, 2825; R. I. 334).

THIRD: Western's relationship to the Bell system has enabled the Bell Associate Companies to purchase their materials at low prices and the advantages arising out of this relationship have not been retained by Western, but have been passed on in prices charged to its Bell customers. In this connection, the statutory court, in its opinion, said:

> "The Western Electric Company, because of its relationship with the Bell System, has no sales expense and no credit risk involved in its Bell business. By receiving advance estimates from the Bell Associate Companies of their requirements, it is able to plan its manufacturing work more efficiently and economically. These factors result in reducing Western's costs, but they are not advantages retained by Western since such reductions in costs are passed on by it in prices charged to its Bell cus-

> tomers. As a result of this relationship, Western has been enabled to sell and has sold its manufactured articles to its Bell customers at lower prices than otherwise would have been possible" (R. III, 2507; R. I, 412, 418).

FOURTH: Western's earnings on its investment in its dealings with its Bell customers have always been low. (Finding 18, R. III, 2518). Its earnings on average investment in its Bell business, after making the adjustments referred to in Finding 17 (R. III, 2517), were 5.9 per cent. for the period 1916 to 1932, and 6.1 per cent. for the period 1923 to 1932. For the same periods its earnings in its Bell business on average investment less the amount of its depreciation reserve account were 7.6 per cent. and 8 per cent. respectively (Finding 18, R. I, 2518).

FIFTH: In determining the reasonableness of Western's earnings consideration must be given to a period of years for the reasons thus stated in the statutory court's opinion:

> "Western's relationship to the Bell system is permanent, not casual. It supplies substantially all of the requirements of all the Bell associated companies for telephone apparatus and lead covered cable at all times. It is, therefore, necessary in arriving at what are reasonable earnings on investment and profit on sales in the Bell business of Western to take into consideration the results for a period of years and not merely a single year" (R. III, 2507; R. I, 329, 440).

While not a subject of any finding, the undisputed testimony showed that earnings on the average of 10 per cent. of the book cost of Western's assets devoted to its Bell business would have been fair (R. I, 414, 430, 449, 520).

SIXTH: Western's earnings on its investment in its Bell business and on its investment less the amount of its depreciation reserve account have been substantially one-third lower than those of other manufacturing companies whose risks and hazards make them fairly comparable with Western (Opinion, R. III, 2508; Exhibit A-271, R. V, 3150; Exhibit A-85, R. IV, 2823; R. I, 333).

SEVENTH: In figuring the percentage earnings of Western, the base used was an extremely conservative one. The statutory court, in speaking of Western's investment, said:

> "The term 'average investment' of Western Electric Company, as used in the findings, includes its plant and manufacturing facilities, merchandise, receivables and cash, less current accounts payable, all at cost to Western except merchandise, which is cost or market, whichever is lower. There is not included in Western's 'average investment' any amount for patents, good will, development expense, or going concern value. A large part of Western's manufacturing plant and facilities have been constructed by it at less than they could have purchased from others, and these savings are reflected in its 'average investment.' Western's factories are advantageously located, well designed and equipped for efficient and economical operation. It maintains a group of engineers who plan its manufacturing operations and constantly study the problem of cheapening its products" (Opinion, R. III, 2507; R. I, 330, 342; Testimony of Stoll, R. I, 486 *et seq.*).

The evidence clearly establishes that Western's relation to the Bell operating companies contemplates, and, as a matter of consistent policy, has involved the lowest prices

consistent with reasonable earnings, and that Western's margins for profit have been narrow. Instead of accumulating large profits, Western consistently and as a matter of policy reduced its prices during the years of expanding business so that at the end of the year 1929, as stated, its price levels for telephone apparatus were only 58.3% of its price levels at the end of the year 1920. What it did in November, 1930, was merely to restore prices to the levels on which they had been prior to the 1929 reduction, and thereby, enable itself to earn 4.2% on its investment in 1931, and to keep its loss for the year 1932 to $6,400,000.

The conclusion and finding of the statutory court that amounts represented by the 10% price restoration in 1930 must be eliminated from the valuation of plaintiff's property is in effect a decision that the test of reasonableness of earnings may operate only one way, that is, when prices can be reduced, and may not operate when its effect is to increase prices.

The ultimate question to be determined in connection with the Western Electric relationship is whether the prices for its materials included in the valuation of plaintiff's intrastate property and its operating expenses have been reasonable. Under the decision of this court there was nothing to justify the statutory court in the rejection of this price increase, it having been clearly established that after the increase became effective, Western's prices to the plaintiff were lower than prices of other manufacturers for comparable materials and its earnings reasonable.

3. The court erred in its finding of fair value of plaintiff's intrastate property by making an undervaluation, in addition to that complained of under Point 2 of more than $14,000,000 for 1931 and more than $23,000,000 for 1932 (Assignment of Errors 1 to 6, inclusive).

The reasons which impelled the statutory court to make the deduction complained of are thus stated in its opinion:

> "The valuation of plaintiff's property for 1931 and 1932 presents some difficulties which are not present in the other years. We are obliged to take notice of the general decline in the property values which has accompanied the present period of business stagnation. For this reason we cannot take the reproduction estimates, based on the cost of labor and materials stated in the record at their face. We have fixed values, therefore, for 1931 and 1932, which in our opinion give due consideration to the elements of the present general declining values."

The statutory court does not state either in its opinion or its findings the amounts by which it reduced plaintiff's reproduction cost estimates in the years 1931 and 1932 on account of the general decline in property values, but such amounts can be readily calculated as shown below,* and are in excess of $14,000,000 for 1931 and $23,000,000 for 1932.

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* The difference between plaintiff's reproduction cost estimate depreciated and all other elements of value as found by the court and the court's finding of fair value for the year 1931 (after allowance is made for the Western Electric price adjustment discussed under Point 2) is $15,351,509, which related to plaintiff's intrastate property gives a reduction in excess of $14,000,000 on account of such general decline in property values. For the year 1932 the court's finding of fair value is more than $12,000,000 below its 1931 finding. By the same process $9,000,000 of this is attributable to the reduction in the intrastate value of plaintiff's property due to such decline or a total of $23,000,000 for 1932.

It must not be assumed from the above-quoted statement from the opinion of the statutory court that for the years prior to 1931 it adopted plaintiff's reproduction cost estimates. This is not the fact. If there be deducted from the Court's finding of fair value for each of the years from 1923 to 1930 the sum of the elements of value found separately by the court, viz., going value, materials and supplies, cash working capital and construction work in progress, the resulting figure will represent the sum at which the court ultimately found the fair value of the structural elements of the property. Such figures are below plaintiff's estimate of reproduction cost of such structural value less the existing depreciation as found by the court, by the following amounts:

	Intrastate Property
1923	$4,287,348
1924	1,964,686
1926	5,395,059
1928	4,341,495
1929	2,675,978
1930	7,816,125

* In only two years, 1925 and 1927, do the court's findings of fair value exceed the aggregate of the elements of value separately found and the structural values as ascertained by the company and such excess is less than $3,000 for 1925 and less than $70,000 for 1927.

The court's error in making the deductions complained of arises out of the fact that plaintiff's reproduction cost estimates for the years involved in this case were not based upon general commodity prices prevailing during that period, but were based upon actual prices paid by plaintiff to Western Electric Company for materials and upon labor

costs actually experienced by the company (R. I, 34; R. II, 1301). Western's prices were constantly reduced from 1923 to 1929, although general commodity prices remained substantially unchanged and other manufacturers were maintaining or increasing their prices. Full consideration was given in the company's appraisal for 1931 to all conditions which had resulted in lessening the value of this property.*

The reproduction cost estimates of plaintiff for all of the years in controversy were not only conservative (R. II, 1312, 1322, 1307), but were based upon prices below those at which the property could have been reproduced except for the advantages resulting from the Western Electric relationship (see *supra*, pp. 39 to 43).

In dealing with reproduction cost based upon such standards of value, it was improper to make further reductions in the years 1931 and 1932 on account of a general decline in property values due to business stagnation, as will appear from an examination of the four major items of plaintiff's physical property: (1) buildings, (2) real estate, (3) materials purchased from Western, and (4) telephone construction labor.

1. Plaintiff's estimate of the reproduction cost of its buildings as of December 31, 1931, was reduced by the sum

*The introduction of evidence in this case was commenced February 23rd and concluded July 1st, 1932, hence no reproduction cost estimate was made by plaintiff for 1932 nor did the court find reproduction cost new for 1932, but it did find fair value for that year. The plaintiff made net additions to its plant in 1931 of $4,135,948 (Exhibit A-57, R. IV, 2777) so that the value as found by the court for the plaintiff's average property in 1931 related to a plant whose book cost was substantially $2,000,000 higher than in 1930 and for the year 1932 to a plant whose book cost was substantially $4,000,000 higher than in 1930.

of $4,500,000 or approximately 25 per cent below its 1930 estimate. These figures, based upon the undisputed testimony and fairly measuring the reduction in building costs, were reflected in the court's finding of fair value for 1931 and 1932. (Exhibit A-17, R. IV, 2679-2680; R. I, 62.)

2. Plaintiff's appraisal of the value of its real estate as of December 31, 1931, was reduced by the sum of approximately $350,000 or 10 per cent below its 1930 estimate. This appraisal, likewise based upon undisputed testimony and reflecting the actual market value of real estate in Chicago during the years 1931 and 1932, was reflected in the court's findings of value. (Exhibit A-18, R. IV, 2681; R. I, 63.)

3. The portion of plaintiff's property consisting of Western materials is included in the valuation at prices lower than they could have been purchased from others and at prices which yielded Western low profits on sales and earnings on investments. (See *supra*, pp. 41, 42.) The effect of Western's policy of reducing prices so that it would make no more than a reasonable profit is strikingly evidenced by the fact, established by the undisputed evidence and found by the court, that its prices for telephone apparatus at the end of 1929 were only 58.3 per cent of what they had been on December 31, 1920 (Opinion, R. III, 2508; also see *supra*, p. 44).

The reductions made by the statutory court on account of the general decline in property values, amounting to more than $14,000,000 in 1931 and $23,000,000 in 1932, were clearly not intended by the court to be made on account of Western's prices. The court found that West-

ern's prices and profits had never been unfair or unreasonable except for the price increase of 10 per cent. made in November, 1930 (Findings 20 and 21, R. III, 2519; see also *supra*, pp. 36-44). The court, having made this finding, refused to give effect to the price increase and thus reduced plaintiff's valuation for the years 1930, 1931 and 1932 by the entire amount by which it deemed Western's prices excessive. It is thus clear that the reductions now under discussion were not intended to be applied because of Western's prices.

Such reductions cannot be related to appellant's buildings, its real estate, or the cost of its materials for the reasons above indicated. It remains only to examine the labor costs in the company's appraisal in order to ascertain whether any rational basis exists for such reductions.

4. The labor costs in the company's appraisal were based upon the wages actually paid by the company (R. II, 1301). Such wages were not criticized by any witness and are not challenged here.*

It is clear that no justification can be found for a reduction in the labor costs used by plaintiff in its reproduction estimates.

The period from 1923 to 1929, inclusive, was one of a fairly stable price level for wholesale commodities and of a slightly increasing price level for labor costs. (See *supra*, p. 41.)

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* By agreement of the parties, Sloan's detailed exhibits showing labor costs for all of the years subsequent to 1923 have been omitted from the record, and the defendants have agreed that they will not in this court "urge that the plaintiff has failed to sustain its burden of proof by reason of the fact that said Exhibits A-3 to A-10 are not in the record in the Supreme Court" (R. III, 2594).

Notwithstanding these facts, the reproduction cost estimates of plaintiff, because of reductions in Western Electric prices and only moderate increases in the wages actually paid by the company, were steadily downward. It is thus apparent that plaintiff's valuation of its property was not based upon general commodity prices prevailing during this period, nor upon labor costs experienced by others nor upon increased property values prevailing during such period. If such a valuation had been claimed by the plaintiff and allowed by the court, then a reduction on account of the decline in general commodity prices and labor would have been appropriate for the years 1931 and 1932. The reductions made by the court unjustly and unfairly penalize the plaintiff, because its reproduction costs have never been measured by such standards.

II.

Expenses.

The court disallowed in each year substantial portions of certain of plaintiff's reasonable and proper operating expenses, namely (1) annual depreciation expense (2) license contract payment, and (3) maintenance expenses, which we now discuss in the order stated.

1. The statutory court's allowance for the annual charge for depreciation is less in each year than the reasonable and proper amount shown by the evidence. Such deficiency in the allowance in the several years ranges from approximately $1,100,000 to $2,100,000.

(Assignments of Error, 9 (a), 11, 16, 17, 18, 19, 20, R. IX, 4962.)

In remanding the case this court instructed the statutory court to determine, among other matters, "the amount which in fairness both to public and private interest should be allowed as an annual charge for depreciation," and to "make appropriate findings with respect to the amount to be allowed in this case as an annual charge for depreciation in connection with the intrastate business."

The statutory court in its opinion, after quoting from the opinion of the Supreme Court herein, said:

> "In determining the amounts which should be allowed as annual charges for depreciation, we have given consideration to the estimates in the orders of the Illinois Public Utilities Commission and Illinois Commerce Commission, to the adjustment of such estimates which is necessary to place them on the basis of the present value of the property for the respective years for which such estimates were made by the commission, to the amounts set up by plaintiff on its books for that expense, to the adjustments of the amounts set up by plaintiff on the basis of original or book cost to make the amounts of such allowances correspond with the present value of the property at the time such amounts were set up on the books of the company, to the experience of the Illinois Company and to the results shown in comparable conditions by other companies which are a part of the Bell system. From a consideration of the evidence on the subjects above stated, we have determined the amounts which in our opinion are reasonable and proper amounts, fair alike to public and private interest, to be allowed as the annual charges for depreciation applicable to the intrastate portion of plaintiff's Chicago area property."

The finding of the court is as follows:

> "26. The reasonable and proper amount to be allowed as the annual charge for depreciation applicable to the intrastate portion of plaintiff's said Chicago area property for each of the years 1923 to 1931, inclusive, is as follows: 1923, $4,000,000; 1924, $4,250,000; 1925, $4,750,000; 1926, $5,400,000; 1927, $6,000,000; 1928, $6,650,000; 1929, $7,000,000; 1930, $7,200,000; 1931, $7,400,000" (R. III, 2520).

The following table shows for each year the amount found by the trial court, the amount shown by the evidence as claimed by the company, and the difference.

	Amount Found by Court	*Amount Claimed by Company*	*Difference*
1923	$4,000,000	$5,662,154	$1,662,154
1924	4,250,000	6,382,159	2,132,159
1925	4,750,000	6,768,618	2,018,618
1926	5,400,000	7,217,128	1,817,128
1927	6,000,000	7,608,468	1,608,468
1928	6,650,000	7,981,108	1,331,108
1929	7,000,000	8,148,888	1,148,888
1930	7,200,000	8,581,118	1,381,118
1931	7,400,000	8,934,628	1,534,628

(Exhibit A-267, R. V, 3145; Exhibit A-48, R. IV, 2705, 2716, 2723.)

The amount of this item of expense is large, and its substantially correct determination, year by year, is important. The expense is actual and cannot be controlled or affected by findings. If the company underestimates what this expense will be, it will, in the long run, lose the difference, because it can never make up any past deficiency. *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, 13-14.

The Company Has Conformed to the Commission's Accounting Requirements.

The company determines the amount of this annual charge to expense, which is charged on the books in monthly installments, by the *straight line method* of depreciation expense accounting. This has been the practice of the company for more than twenty years, and during all that time it has been required by law, as we shall show.

The straight line method is prescribed by both the Interstate Commerce Commission and the Illinois Commission and hence, being also inherently sound, it is required by law.

The Interstate Commerce Commission in 1912, by an order effective January 1, 1913, promulgated the Uniform System of Accounts for Telephone Companies. We think the court will take judicial notice of the provisions of this system of accounts, but in any event, plaintiff's Exhibit 3 (O.R. IV, 1183-92) sets forth the provisions immediately pertinent for our present purposes. (See especially Section 23, pp. 1190-91.) The text has been carried out and applied by the Interstate Commerce Commission in all that it does to administer this system and see that it is followed by the companies. The testimony upon both trials shows fully and in detail what this system of depreciation accounting is and how the annual amount of the charge is to be determined. The record leaves no room for doubt or difference of opinion with respect to the basis and method prescribed by the Interstate Commerce Commission.

The Illinois statute provides that the system of accounts established by the Commission and the forms of

accounts prescribed by it "shall not be inconsistent" with those established from time to time by the Interstate Commerce Commission (O.R. I, 75).

The Illinois Commission has adopted the accounting system and methods of the Interstate Commerce Commission. It is stipulated of record that the two systems are identical (O.R. II, 152. See also O.R. I, 222; O.R. II, 748; R. I, 222; R. I, 255).

The company has complied with these requirements at all times. Its witnesses repeatedly testified that the company's accounts have been kept in accordance with the rules prescribed by both commissions. This testimony was given by the Vice President in charge of accounting, by the operating Vice President, by the General Accountant (R. I, 221-2) and by Andrew Sangster, a Certified Public Accountant in general practice (R. I, 255). It is not contradicted.

U. F. Cleveland, Vice President in charge of the Accounting Department of plaintiff, testified upon the former trial:

> "I believe the books of account of the company have been kept in accordance with the Uniform System of Accounts since January 1, 1913. The company has kept a complete and separate set of books of account since 1908 showing the revenues and expenses of its Chicago business. That separate set of books of accounts has also been kept in accordance with the Uniform System of Accounts" (O.R. II, 165).

The Illinois Commission had full knowledge of the way in which the accounts were kept and of the facts as recorded by the company. The books and records were subjected to continuous examination and supervision by the Com-

mission's staff, *who had an office assigned to them at the company's headquarters for that purpose.* In only one instance was anything criticized and that was a minor matter not related to depreciation accounting (O.R. II, 807).

F. O. Hale, then Operating Vice President, now President of plaintiff, testified upon the former trial that the amounts of money charged by the company in each of the years 1923 to 1928 for the expense of depreciation in the operation of its Chicago property were determined in accordance with the accounting rules of the Interstate Commerce Commission and the Illinois Commission and represented the best judgment of the company (O.R. II, 890).

He testified further, referring to this same subject:

> "I think the company complied fully with the intent and purpose of Section 23 of the Uniform System of Accounts. We never, to my knowledge, received any complaints from the Interstate Commerce Commission or the Illinois Commerce Commission as to our non-compliance with those rules" (O.R. II, 919).

K. E. Tholin, *an accounting officer of the Illinois Commission and a witness for the Commission at both trials,* testified concerning the close scrutiny the Commission has exercised continuously since 1921 over the books and records of the plaintiff and in particular over the depreciation accounts. On cross-examination by Mr. Bangs at the first trial, he testified as follows:

> "* * * We have had jobs in connection with your books since 1921. Some of our men are investigating there now. We have been continuously examining books of the plaintiff since 1921 in some case or other. I think there are about five or six men

there right now and at times we might have had a few more than that and at other times we probably had only one or two there. It might be that the number would average around three'' (O.R. V, 1854).

Referring specifically to what the company's books show with respect to the amount actually charged for expense of depreciation and the entire matter of the accounting in that respect, he further testified:

''Our accountants in all cases make a report of what the depreciation reserve and the depreciation accounting on the company's books have resulted in, showing what the debits are and the credits are to the reserve and how much is charged in expense; that is a part of our regular accounting report and that has been done in all cases. * * *'' (O.R. V, 1854-55).

Presumably this witness was put forward by the Commission as its spokesman in this case. Although the Commission had full knowledge throughout these years both of the accounting principles and procedure and of the actual entries upon the company's books, according to his testimony, he is silent as to any word of objection or criticism made by the Commission during all these years, thereby confirming the testimony of plaintiff's witnesses referred to above. The Commission's supervision and continuous check of the company's books, requiring the full time of several men and an office specially set aside for their use at the company's headquarters, presumably was for the purpose of assuring that the accounts were being properly kept at all times.

The company is required to file an annual report with the Interstate Commerce Commission showing, among other

matters, the rate and amount of depreciation expense charged during each year (Hale, O.R. II, 886).

The Straight Line Method.

This method of charging for depreciation expense, the straight line method, is designed to spread evenly over the service life of the property the loss which is realized when the property is ultimately retired from service. Under the prescribed accounting system the loss is computed upon the actual cost of the property as entered upon the books, less the expected salvage. The amount to be charged each year is one year's pro rata share of this total amount. It is necessary, therefore, to determine the expected service life and the expected salvage. (For example, if service life is 20 years and salvage is 10% the annual charge on the books is 4½% of the cost.) Because of the character of the business, the size and complexity of the property, the many different classes of plant of widely different characteristics, some having very long and others very short lives, some yielding large salvage and others little or no salvage (or even negative salvage, on account of the cost of removal), and because of the very large number of units of a class, averages must be used—the average service life and average salvage of poles, of telephones, etc. Also because of the facts just referred to it is necessary to determine the amount of the annual charge for each class of property separately. That is, a separate annual rate is computed from the service life and salvage of the particular class of property, and the rate thus obtained is applied to the cost as shown by the books to obtain the amount to be charged. One-twelfth of the rate is applied to the property

standing on the books each month. The methods and all the processes by which it is determined are set forth fully in the evidence hereinafter discussed.

But the amount charged on the books under this method of accounting is not the measure of the company's constitutional rights. The property was provided new and it is that property which is used up in giving the service. The company is entitled to have returned to it during the period of its use the money equivalent of the same property new (less salvage) at the time it is retired from service. In the evidence in this case, therefore, the charges made on the books have been recomputed upon the basis of the replacement value of the property new, by applying the depreciation rates for each class of property to the reproduction cost new as shown by the company's appraisal and found by the court. This is in accordance with the decision of this court in *United Railways* v. *West*, 280 U. S. 234.

The Evidence Sustains the Amount Claimed by the Company.

The company developed in regular course of its business definite percentage rates to be applied to each separate class of its property in order to arrive at the annual depreciation charge. The percentages so developed by the company, when combined and expressed as a composite rate applicable to the entire depreciable property, are as follows:

COMPOSITE DEPRECIATION RATES

(Based on average plant in service and office furniture and fixtures but excluding land and right of way)

Year	*Per Cent.*
1923	4.926
1924	4.595
1925	4.694
1926	4.766
1927	4.793
1928	4.850
1929	4.733
1930	4.775
1931	4.790

The arithmetical average for the nine years is 4.72 per cent. (Ex. A-127, R. IV, 2859).

With reference to the variations in the percentages for the different years, it will be noted that these reflect both changes in class rates during the period and changes in the relative amounts of the property of the different classes. This is so because the charges to expense are determined by applying the separate class rates to the respective classes of property. The class rates are continuously reexamined in connection with the current studies of service life and salvage, constantly being made, and the rates are changed if and as indicated by the result of those studies. Exhibits A-125 (R. IV, 2853-7) and A-126 (R. IV, 2858-9).

The following table shows the amounts of depreciation expense, corresponding to the above depreciation rates, actually charged on the books of the company (column 2) in each of the years, and the amounts adjusted to the current value new (column 3), in accordance with the decision of this court in *United Railways* v. *West, supra,* page 58:

PLAINTIFF'S DEPRECIATION CHARGES AS MADE AND AS ADJUSTED.
INTRASTATE PORTION OF PROPERTY—CHICAGO AREA.

Calendar Year	*On Original Cost Basis, Per Books*	*On Current Replacement Value New of Same Property*
(1)	(2)	(3)
1923	$4,221,515	$5,662,154
1924	4,469,890	6,382,159
1925	5,048,013	6,768,618
1926	5,767,372	7,217,128
1927	6,334,580	7,608,468
1928	7,009,065	7,981,108
1929	7,436,480	8,148,888
1930	7,864,772	8,581,118
1931	8,133,289	8,934,628

(Exhibit A-267, R. V, 3145; Exhibit A-48, R. IV, 2705, 2716, 2723).

The amount for each year shown in column 3 of this table is the amount claimed by the company in this case.

In support of the reasonableness of these figures the plaintiff called Mr. John R. Turner as its chief witness. He has charge of all studies and investigations for determining service life and salvage of the company's property and the resultant depreciation rates. His oral testimony covers 125 pages of the printed abstract, and complete references to it and his exhibits are given at the foot of this section, page 75. Mr. Turner succeeded on this work Mr. F. O. Hale, now president of the company and formerly its chief engineer, who was the company's principal witness on this subject at the first trial (see references to Mr. Hale's testimony at the foot of this section, *infra*, p. 75).

Exhibit A-125 (R. IV, 2853-7) shows the depreciation rates for each class of plant used by the company for the years 1923-30, and shows also the life and salvage expectancies from which the rates are derived. Exhibit A-126 (R.

IV, 2858) gives the same data for the year 1931. Exhibit A-127 (R. IV, 2859) shows the dollar amounts resulting from the application of the foregoing depreciation rates to the cost of the property of each class standing on the books month by month. These are the amounts charged in each year, by monthly charges, and entered on the books in the expense account entitled "Account 608—Depreciation of Plant and Equipment," as provided in the Illinois Commission's system of accounts.

Exhibit A-128 (R. IV, 2860-83) sets forth fully and in detail the character of data available in the company's recorded experience, the methods by which these data were analyzed and interpreted by Mr. Turner, and the processes by which he reached his conclusions, with respect to the service lives and percentages of salvage. In his oral testimony, he amplified and elucidated the descriptive matter of the exhibit (R. I, 754-98). It is not feasible to condense this further in a brief.

Defendants themselves showed that the method followed by Turner was an exact application of the straight line depreciation practice as defined by the Interstate Commerce Commission and the Illinois Commission. Exhibit D-123 (R. VI, 3776-3807) was offered and received in evidence on the part of the defendants (R. II, 1210), being a paper entitled "The Straight Line Depreciation Practice of Telephone Companies in the United States," presented before the International Congress on Accounting in September, 1929, by Allan B. Crunden and Donald R. Belcher. The authors, together with Mr. Woodford, were the witnesses who appeared and testified for plaintiff and all other operating units of the Bell System before the Interstate Commerce Commission in the depreciation case, "Tele-

phone and Railroad Depreciation Charges," representing the "central organization of a few carefully selected engineers and accountants" (referred to by the Interstate Commerce Commission and by this court in its opinion), maintained by the American Telephone and Telegraph Company as a part of its staff for carrying out its obligations under the License Contract.

This paper is comprehensive in scope, though of course not exhaustive, and non-technical so far as the nature of the subject permits. It is an exposition particularly of the way depreciation accounting is handled throughout the Bell System. The evidence shows that plaintiff has employed and correctly applied the accounting principles, methods and procedures set forth in this paper. In view of this, we do not discuss here at any length the phases of the subject covered there.

Comparison With All Other Bell System Companies.

Referring to this subject, this court said:

> "* * * The experience of the Illinois Company, together with a careful analysis of the results shown, under comparable conditions, by other companies which are part of the Bell system, and thus enjoy the advantage of the continuous and expert supervision of a central technical organization, should afford a sound basis for judgment as to the amount which in fairness both to public and private interest should be allowed as an annual charge for depreciation."

Mr. L. G. Woodford was plaintiff's witness to make such an analysis and comparison. He is a telephone engineer employed in the Operation and Engineering Department of the American Telephone and Telegraph Company,

who, since the Interstate Commerce Commission has been actively investigating telephone depreciation rates and practices with a view to fixing the rates, has devoted his time almost exclusively to this subject. He represented all Bell System Companies as the engineering witness in the depreciation hearings before the Interstate Commerce Commission (R. II, 1203). His duties during the period covered by this suit have pertained almost exclusively to methods for studying service life and salvage of the various classes of telephone property and advising and assisting the operating companies of the Bell System in the application of those methods. He heard Mr. Turner's testimony, examined his exhibits and testified to his familiarity with the methods that were used in Chicago in 1923 and succeeding years and with the methods of all the operating companies of the system. He testified that the methods used throughout the system during the entire period have been substantially the same in all respects (R. II, 1178-79).

Mr. Woodford placed in the record detailed exhibits showing comparisons of what the depreciation expense of each of the other companies actually was and what it would have been if each company had used the rates used by the Illinois Bell Telephone Company in the Chicago Area (Exhibit A-203, R. V, 2982; R. II, 1185, 1201, 1392). The comparisons were made in this way for the reason that the various companies have different amounts of the various classes of plant, and to obtain a fair comparison it is necessary properly to weight the classes of plant. There was also a comparison made between the rates for the City of Chicago and the rates for the City of New York (Exhibit A-265; R. V, 3144; R. II, 1393).

These comparisons showed that for the entire period 1923 to 1931 the depreciation rates of all the other Bell Companies, taken as a whole, were slightly higher than the Chicago rates; that of the individual companies, 12 companies had in effect rates as high as or higher than, and 8 companies had in effect rates lower than, those in effect in Chicago; that the rates of three companies operating solely or in large part in single large cities were in each case as high as or higher than the Chicago rates; and that the rates for New York City for the three years 1929, 1930 and 1931 (the only years during which separate rates were applied in New York City) were substantially higher than the Chicago rates. (Exhibits A-203, R. V, 2982; A-265, R. V, 3144; R. II, 1185-7 and 1392-3.)

Mr. Woodford's testimony, of course, is not questioned or disputed in any respect whatever, so far as his statement of the facts is concerned. A very brief cross-examination, however, suggested a doubt as to the comparability of the rates of the different companies (N.R. IV, 1201). Of course, all that it was possible to do was to make the comparison. It is not possible to draw more out of this than there is in it. The rates of the various companies depend upon multitudinous differences in local conditions impossible of definite evaluation. That is true in the nature of the case. The record shows what the various disparate factors are in general, and that is all it can show in this respect.

It does not follow that the comparison does not mean anything. On the contrary, it is of undoubted significance and tends strongly to sustain the Chicago rates as being reasonable and proper rates. The accounting systems of all the companies are identical. The same methods of ascer-

taining service life and salvage expectancies for the same classes of plant are employed by all the companies. The line of demarcation between maintenance expenses and retirements charged to the depreciation reserve is drawn the same in all cases. The properties of the several companies are chiefly of Western Electric manufacture and are largely standardized throughout the System. The maintenance practices are similar. The art progresses with substantial uniformity for all because it is the telephone art of the Bell System (R. 11, 1179, 1201).

Certainly there is nothing in the analysis and comparison prepared and introduced by Mr. Woodford which would give the slightest indication that the Chicago rates may be out of line with telephone depreciation rates generally throughout the country, and it is fair to say, as we have said, that *the comparison has substantial probative weight in support of the Chicago rates.*

The Statutory Court Erred in Giving Any Weight to the Commission's Orders.

The statutory court stated in its opinion that it had "given consideration to the estimates in the orders of the Public Utilities Commission and Illinois Commerce Commission." Two orders are referred to, namely the 1920 Order of the former commission (Public Utilities Commission) which prescribed the telephone rates effective January 1, 1921 (O.R. IV, 1281, 1297), and the 1923 Order of the defendant commission which fixed the telephone rates involved in this suit. This order is attached to the bill of complaint (O.R. I, 1446).

The court erred in giving any weight to these orders for two reasons: First, they were not competent evidence. It is surely not proper to consider as evidence the determination by the Commission of one of the disputed matters of fact upon which the order alleged to be confiscatory is based. Second, the orders show upon their face that they had no solid basis and that they are contrary to established accounting rules and principles of law.

The 1920 Order.

This order shows upon its face that it was not soundly based and was a temporary expedient of the postwar readjustment. After rejecting the contention of the City in that case, the Commission refers to the "reserve against depreciation" of $16,000,000 for the Chicago property, and says that any further additions to the reserve "*are unnecessary and should not be allowed during the present period which is one of general financial readjustment*" (p. 1299). But the expense is a fact, goes on in years of depression as well as in those of prosperity, and under the accounting rules of the Interstate Commerce Commission and of this Commission must be spread *evenly* over the life of the property. Under the established rule of law inadequate charges in any year can never be made up. *Knoxville* v. *Knoxville Water Co., supra.*

Moreover, the 1920 order, even if it had been correct then, could have no bearing upon the proper amount in 1923 and subsequent years, both because of the lapse of time and because it is superseded by the 1923 order of the defendant Commission.

This Commission also commits the same fundamental error that underlies the action of its successor in dealing

with this matter in the 1923 order, which we discuss, *infra*, p. 72.

This order is clearly without any value as an indication of proper depreciation charges in accordance with sound accounting and settled legal rules.

The 1923 Order.

The Commission made the following finding with respect to maintenance and "*retirement charges*" combined:

> "(11) That a fair allowance to take care of maintenance and retirement charges for said property in use as of December 31, 1922, is $7,869,400, and that this sum, plus 8¾ per cent. of all additions and betterments, will be sufficient and adequate to permit the Illinois Bell Telephone Company to properly maintain its Chicago property" (O.R. I, 44).

In this finding the Commission abandoned "depreciation accounting" altogether and in plain violation of its own accounting system substituted "retirement accounting" in its place.

The distinction between depreciation accounting and retirement accounting is fundamental. The Interstate Commerce Commission recognizes the distinction in its "Report on Further Hearing," *Telephone and Railroad Depreciation Charges*, 177 I. C. C. 358-9:

> "Question has arisen as to the meaning of this statutory provision. At the outset it will be well to define certain terms which will be employed frequently hereinafter. Most property units used by a railroad or telephone company are retired from time to time for various reasons. Units so retired may be replaced in kind or by an improved substitute

> or not at all. It is conceded that the loss involved in such retirements is an expense of operation. Broadly speaking, there are three methods of accounting for such loss. It may be charged in bulk at the time of the retirement of the unit; or it may be anticipated and spread, as nearly as may be, over the service life of the unit by periodical charges, usually annual or monthly; or it may be spread by periodical charges over a period subsequent to the retirement. We shall term these methods, respectively, retirement accounting, depreciation accounting, and future accounting."

Under the method of "retirement accounting" thus adopted by the defendant Commission in its 1923 order, instead of charging annually a year's proportion of the cost of the property (less salvage) and thus accruing an amount equal to such cost in even annual increments throughout the period of use, which is depreciation accounting, the company is in effect denied the right to recoup any part of the cost of the property until the property is gone. That is the principle upon which the Commission acted and that would have been the approximate result.

Before analyzing this finding to show the gross inadequacy of the amount of the "retirement charges" which it produces, we wish to point out that it is void upon two other grounds.

First, "maintenance" is a separate category of expense in the Commission's accounting system, as it is in all accounting systems, so far as we know. There has not been any dispute whatever at any time during the period of this case with respect to the amount of the company's maintenance expenses as shown by its books. Of course, they necessarily vary in amount from year to year, as

wages and the price of materials, the operating conditions in the plant, the policies of the company, etc., change. Under the Commission's formula contained in this finding, as the maintenance expenses vary on account of these and other causes, the "retirement" allowance will automatically change inversely in the identical amount. Such a formula is arbitrary and void on its face.

Second, this finding is in plain violation of the provision of the Illinois statute by which the Commission was governed and which defines its authority to regulate the annual depreciation charges of public utilities subject to its jurisdiction. Section 14 of the Public Utilities Commission Act of Illinois is as follows:

> "Section 14. The Commission shall have power, after hearing, to require any or all public utilities to keep such accounts as will adequately reflect depreciation, obsolescence and the progress of the arts. The Commission may, from time to time, ascertain and determine and by order fix the proper and adequate rate of depreciation of the several classes of property for each public utility; and each public utility shall conform its depreciation accounts to the rates so ascertained, determined and fixed" (O.R. I, 76).*

The Commission did not fix any depreciation rates for the several classes of property, either "proper and adequate" or otherwise. It did not attempt to "ascertain

* This provision, it will be observed, is entirely consistent with the Interstate Commerce Commission's system of accounts, and is therefore also entirely consistent with the other provision of the Illinois statute, referred to herein, *supra*, pp. 53-54, which requires any system and all forms of accounts prescribed by the state commission to be in conformity with those of the Interstate Commerce Commission.

and determine" such rates, or even an over-all composite rate to be applied to the entire depreciable property, although the latter would not have conformed to the statute. If it could be supposed that the Commission was attempting to find the amount in dollars which would represent a proper and adequate annual depreciation allowance the formula of this finding would be arbitrary and a nullity. But the fact must be that the Commission was not concerning itself at all with depreciation expense charges in this finding. Obviously it was not making a depreciation order, which it would expect the company to comply with. The Commission, we repeat, abandoned depreciation accounting altogether in this finding. Its action is void.

The Amount Allowed by the 1923 Order is Grossly Inadequate.

We have already referred in a previous section, *supra*, p. 28, to the great rapidity with which the property grew during the period of this suit. In the nine years 1923-31, new plant was added (gross additions) to the amount of $189,000,000. Retirements were $79,000,000. Net additions were $110,000,000. These are book figures. The company's investment in property at actual cost was more than doubled. On January 1st, 1923, this investment was $83,000,000, and on December 31, 1931, it was $195,000,000 (O.R. I, 18; Ex. A-58, R. IV, 2778-9). The gross additions were spread fairly evenly over the period.*

The increase in the depreciation reserve under the Commission's order would have been only $2,200,000. (Table,

* For the various figures here stated see Table, *infra*, Appendix. The figures are not in controversy, so far as we are aware, and the column headings show where they appear in the record.

infra, Appendix, Column F). That is, upon the basis of the Commission's order the company would have been allowed over the period of nine years a net increase of $2,200,000 in the financial provision with which to meet the ultimate loss of its entire investment, which stood on the books at $85,000,000 at the beginning of 1923 and grew to $195,000,000 at the end of 1931. Or if we consider only the nine years' added investment (*i. e.*, net additions) in relation to the net amount accrued over the period in which that investment was made, the figures are, added investment $110,000,000 and net depreciation reserve accrual $2,200,000. The amount actually and correctly charged by the company over the period is $26,000,000 more than allowed by the Commission (Table, *infra,* Appendix, Column E).

To an investment of $85,000,000 at the beginning of 1923 has been added the further investment of $110,000,000 in a period of nine years, not in railroads or waterworks or gas plants, in which the property is long-lived, but in the telephone business, in which the average life of the property, exclusive of underground conduit (Defendants' Ex. D-123, R. VI, 3779), is less than fifteen years. And we are told by the Commission that the measure of the Company's legal right, as declared by this Court in the *Knoxville* case and the *West* case, to make provision against the time when that property will be dismantled and gone because no longer useful is the sum of $2,200,000 in the period of nine years!

No investor in his right mind would put his money into this business on any such basis as that.

Fundamental Fallacy of the Commission.

That there is a fundamental fallacy in attempting to measure depreciation expense by the annual retirement losses, in the case of a rapidly growing property, is clear and well understood. Exhibit D-123 (R. VI, 3776-3807), which is an exposition of the subject of depreciation accounting in a paper published by two experts of the staff of the American Telephone and Telegraph Company and was offered in evidence by defendants as a part of their case, under the caption "Retirement Expense Less Than Depreciation Expense in Growing Properties" (R. VI, 3803), points this out:

> "In a growing plant, the annual retirement losses will be less than the current true annual expense of depreciation and the greater the rate of growth, the smaller the retirement losses will appear in comparison with the current depreciation rate, the reason being, of course, that in a growing plant there are new plant groups in operation on which depreciation is accruing but which are not yet represented, or are but slightly represented, in the retirement losses."

After illustrating the matter by charting an assumed case, the paper continues:

> "For this reason any attempt to ascertain percentages of current depreciation expense to investment in a growing property by dividing the average retirement losses by the average plant in service during the period within which such losses culminated, involves a mathematical fallacy."

Mr. Hale, testifying for plaintiff on this subject at the first trial, pointed out the same fundamental fallacy in what the Commission did. He testified:

> "* * * You have got a rapidly growing plant here, and you have got a life I think that they will admit of at least twelve years, consequently your retirements in any given year must refer on an average to the amount of plant you had in service twelve years before. You have a condition where your plant at least tripled in size in twelve years, and your retirements, by a simple mathematical calculation on that basis, must be approximately one-third of what the depreciation was on your plant for the year in which the retirement takes place * * *" (O. R. II, 315).

This testimony, of course, is undisputed.

We do not suggest that the Commission was not aware of this, although whether it was or not would make no difference. The point is it was allowing only retirement charges in lieu of depreciation expense charges. *That the Commission did not have the legal right to do.*

Neglect of depreciation was one of the historical causes of financial disaster of many of the smaller telephone companies in the United States and the ability of the companies in the Bell System and various of the independent telephone companies to maintain themselves is undoubtedly traceable in part to a better perception of the nature and function of depreciation expense accounting (Defendants' Ex. D-123, R. VI, 3777).

The court *could obtain no help whatever* from the Commission's action in this matter. The Commission simply did not deal at all with the problem that confronted the court. Its action was unsound from every point of view.

In conclusion upon this subject:

The matter here is not one that lies in the field of opinion, in the ordinary sense of the word. The "opinions" of expert witnesses are not ordinarily binding upon the triers of fact. But plaintiff's witnesses in this case did not determine, merely as a matter of their opinion, that a rate of about so much—5 per cent., or 4 or 6 per cent.—would be about right. They would not be willing to rely upon a mere general judgment. They would know that the problem is one that lends itself to statistical and mathematical treatment, although at the same time it cannot be fed into a machine that will turn out the answer, and they would insist upon attacking it in that way. The Bell System has done that. It would be inexcusable if that were not so. The matter is too large and too important both to the telephone companies and their patrons to admit of haphazard treatment. The court would not be satisfied with broad generalizations from plaintiff's witnesses with respect to a matter of this kind.

The company takes up each class of property and studies it separately. There is no basis whatever in the evidence upon which the court could find a rate for any single class of the company's property, or a composite rate for the entire property, different from that used by the company. And to attempt to determine the amount of the charge except upon the basis of service life and salvage, and the appropriate rate resulting therefrom, is indefensible.

That this item of annual expense should be the year's equal share of the value of the property, less salvage, can scarcely be denied or questioned. Plaintiff's evidence shows what this is, and there is no other evidence that

does show it. The court should accept this evidence. If, when that is done, further problems remain for consideration, these should not be allowed to stand in the way of a proper determination of this question, which should be taken within its own four corners.

INDEX TO PLAINTIFF'S DEPRECIATION TESTIMONY.

1. Testimony of John R. Turner:
   Direct examination in chief, R. I, 750-798.
   Cross-examination, R. II, 1097-1129.
   Re-direct examination, R. II, 1130-1138.
   Re-cross-examination, R. II, 1138-1143.
   Further re-direct examination, R. II, 1143-1144.
   Further re-cross-examination, R. II, 1278-1297.
   Rebuttal, direct examination, R. II, 1384-1391.
   Cross-examination, R. II, 1426-1433.

2. Testimony of L. G. Woodford:
   Direct examination, R. II, 1177-1188.
   Cross-examination, R. II, 1188-1203.
   Re-direct examination, R. II, 1203-1204.
   Rebuttal, direct examination, R. II, 1392-1394, 1424-1425.
   Cross-examination, R. II, 1425.

3. Testimony of W. K. Kruse:
   Direct examination, R. I, 230.
   Rebuttal, direct examination, R. II, 1397-1398.

4. Testimony of F. O. Hale:
   Direct examination, O.R. II, 884-893.
   Cross-examination, O.R. II, 893-910.
   Re-direct examination, O.R. II, 910-914.
   Re-cross examination, O.R. II, 914-915.
   Re-direct examination, O.R. II, 915-919.
   Re-cross-examination, O.R. II, 919-921.

PLAINTIFF'S PRINCIPAL DEPRECIATION EXHIBITS.

A-55 Rate of return, with depreciation expense based on reproduction cost (R. IV, 2766-2774).

A-59 Amounts charged compared with amounts allowed by the Commission order (R. IV, 2780-1).

A-60 Reserve balances in amount and per cent. to plant (R. IV, 2782-3).

A-125 Depreciation rates, years 1923 to 1930 (R. IV, 2853-7).

A-126 Depreciation rates, year 1931 (R. IV, 2858).

A-127 Depreciation expense and composite rates, years 1923 to 1931 (R. IV, 2859).

A-128 Study of life and salvage, principal classes of property (R. IV, 2860-2883).

A-129 Study of life and salvage, other classes of property (R. IV, 2884-5).

A-203 Comparison of Chicago depreciation rates with those of other Bell companies (R. V, 2982-7).

A-263 Method of computing annual rate of depreciation for station apparatus (R. V, 3141).

A-265 Comparison of depreciation rates, Chicago and New York City (R. V, 3144).

A-267 Comparison of depreciation expense based on book cost and reproduction cost (R. V, 3145).

2. The statutory court made errors of both fact and law in determining the allowable deductions from plaintiff's revenues on account of the services of the American Company (known as the License Contract Services), which errors resulted in a substantial understatement of such deductions and overstatement of plaintiff's net earnings.

The court below found the allowable deductions above referred to, in its Findings of Fact 22, 23 and 25 (R. III, 2519-2520). Plaintiff took exception thereto in its Assignments of Error Nos. 9 (b), 14 and 15 (R. IX, 4964, 4966).

The "License Contract" between plaintiff and the American Company, which owned most of plaintiff's stock, was one of the matters discussed in the opinion of this court upon the previous appeal (*Smith* v. *Illinois Bell Tel. Co.*, 282 U. S. 133, pp. 153 to 157).

In that discussion this court said:

> "At the time to which the evidence was primarily directed (1923), there was in force a 'license contract' between the Illinois Company and the American Company, granting a license under the patents owned or controlled by the American Company and providing for the payment to the latter of 4½ per cent. of the gross revenues of the Illinois Company covering the rental for the use of instruments and for engineering, financial and advisory services * * *" (p. 153).

Plaintiff set up on its books as expenses the License Contract payments made by it to the American Company and deducted them in determining its net income. Re-

ferring to this practice and to the actions taken with regard thereto by the two Illinois Commissions this court said:

> "The order of the Public Utilities Commission of Illinois, made in December, 1920, which fixed the rates charged in 1923 (the rates still in force under the interlocutory injunction in this suit) had provided that an allowance of $1.13 was reasonable solely for the use of each telephone instrument, that the services of the American Company were of great value to the Illinois Company, that the annual payment under the license contract then averaged $2.10 per station for the City of Chicago, and that this payment was not excessive. The Illinois Commerce Commission, in the order now under attack, continued this allowance of $2.10 per station as sufficient to cover the rental and the services in question" (pp. 153-154).

Referring to the treatment accorded the License Contract by the statutory court upon the first trial of this action, this court said:

> "The Court found that the case for the allowance of the entire amount (paid by plaintiff) for services was a strong one; that on the basis of a total charge of $2.10 per station, as allowed by the state commission, there would be a reduction of $360,000* in the amount chargeable to operating expenses by virtue of the payments under the license contract, and that there was no warrant for any further reduction. Without approving the reduction, the court accepted the ruling of the Commission for the purpose of determining the issue of confiscation" (p. 155).

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* The gross revenue per station was greater in 1923 than in 1920, and hence 4½% of gross amounted to more than $2.10 per station in 1923.

During the period from 1923 to 1929 the percentage of gross revenue charged plaintiff by the American Company for its License Contract service was reduced in several steps from 4½% to 1½%. The benefits rendered were also reduced, but not commensurately* (R. II, 1165; O.R. II, 791, 792).

After commenting upon such reductions, this court closed its discussion of the License Contract as follows:

> "In view of the findings, both of the state commissions and of the court, we see no reason to doubt that valuable services were rendered by the American Company, but there should be specific findings by the statutory court with regard to the cost of these services to the American Company and the reasonable amount which should be allocated in this respect to the operating expenses of the intrastate business of the Illinois Company in years covered by the decree" (p. 157).

Upon this second trial the Statutory Court found the cost to the American Company of furnishing its license contract services and found the reasonable amount thereof which should be allocated to the intrastate business of the plaintiff in the Chicago area (Finding 22, R. III, 2519).

The statutory court also found the amount of the actual payment made by plaintiff to the American Company in each year under the License Contract on account of its Chicago intrastate business (Finding 23, R. III, 2519).

After having made the above findings, the statutory

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* The American Company, in 1928, sold the instruments in question to plaintiff and discontinued that part of the License Contract service represented by the furnishing of said instruments. Otherwise, the services continued the same. In recognition of the reduced service, the License Contract payment was reduced from 4% to 2%. Later further reduced to 1½% (O.R. II, 791-792).

court found the allowable deductions for License Contract services in each year from 1923 to 1931 (Finding 25, R. III, 2520) and plaintiff's net revenues (Finding 27, R. III, 2520).

In making its determination of said allowable deductions the statutory court committed three major errors.

(1) It was plain error on the part of the statutory court to restrict the allowable License Contract deduction of plaintiff in each year to the cost to the American Company or payment by the plaintiff, *whichever was lower.*

In three years of the nine covered by the trial the Statutory Court sustained as proper deductions from revenue, the full amounts paid by the plaintiff to the American Company under the "License Contract" (Findings 25 and 23, R. III, 2519, 2520). In each of those years the court found that the cost to the American Company of rendering the services far exceeded the amount paid therefor by plaintiff, but the court restricted plaintiff's deductions to the amounts actually paid (Findings 22, 23 and 25, R. III, 2519-2520). On the other hand, in six of the nine years the statutory court found that the costs to the American Company of rendering the services were substantially less than the payments therefor and in those years restricted plaintiff's deductions from revenue to the amounts which it found to be the costs to the American Company (Findings 25, 22 and 23, R. III, 2519, 2520).

There was no support in the evidence for the above procedure, and there seems to be no possible support therefor in law or logic under the findings. The American Company rendered necessary and valuable services to plaintiff and twenty-three other operating companies. The American Company was efficient, its operations were conducted upon a gigantic scale, and its costs of performing the license con-

tract services were low (O.R. III, 1045-1046, 1057). This was so in 1929, 1930 and 1931 as well as prior years.

If this contract is one that must be regarded by the Court as binding between the parties and fair and valid for all purposes (which is what the plaintiff claims), then the actual payments made pursuant to its terms must measure the deductions of plaintiff in all years.

The plaintiff protests that there is nothing in the evidence or in the decisions of this court to sustain such a rule, but if the two companies are to be considered as one with respect to the License Contract services, then the expenditures by the American Company would be the equivalent of expenditures by plaintiff itself and plaintiff would be entitled to the cost of such services to the American Company in all years and not only in those when the cost to the American Company was less than the payments therefor.

Based on the foregoing, the deductions allowed plaintiff under Finding 25 for the years 1929, 1930 and 1931 (R. III, 2520) must be increased to the amounts found by the court in Finding 22 for those years (R. III, 2519), or the deductions allowed plaintiff under Finding 25 for the years 1923 to 1928 must be increased to the amounts found for those years in Finding 23 (R. III, 2519). That is to say, the deductions must be on a consistent basis of cost throughout the nine years or of payments throughout the period. The statutory court understated plaintiff's deductions from revenue and overstated its net profit by at least $768,108 by reason of this one error (Findings 22 and 23; R. III, 2519).*

Again accepting the facts stated in the findings and opinion of the statutory court, we find further error in its conclusions as follows:

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* Figures 1929, 1930, 1931.

(2) The statutory court in making its Finding 22 of the fair share of the costs of the American Company which should be allocated to the intrastate business of plaintiff omitted important elements of cost which were found by it.

The opinion of the statutory court (R. III, 2509 to 2512) enumerates what items it included in building up the costs to the American Company of performing the License Contract services in connection with plaintiff's intrastate business.

Such enumeration does not include taxes and other items claimed by plaintiff. Moreover, the statutory court in order to make its procedure certain beyond possibility of doubt states that the American Company incurred expenses for taxes, states the proper share thereof which should be considered as applying to the Chicago area of the plaintiff, but says

> "We have reached the conclusion, however, that these amounts are not covered by the contract and should not be included under the allowance made herein for operating expenses" (Opinion, R. III, 2511-2512).

What the statutory court did is perfectly obvious. This court having sent the case back for further determinations, including the costs of the License Contract service to the American Company, the statutory court naturally wished to make sure that the case would not be sent back again. To that end, it included in the License Contract costs found by it only those items of expense concerning which there could be no question. However, in order to be fair, it found all the facts concerning other expenditures and costs

of the American Company so that this court might include them if it thought proper.

Taking up the item of taxes, one of those dealt with, as immediately above described:

The exclusion from the License Contract costs of all taxes paid by the American Company was clearly erroneous. The court does not find that the taxes had nothing to do with the rendering of the License Contract services. On the contrary, it states that if the taxes paid "were distributed in accordance with the percentages on which the actual costs to the American Company of its twelve departments were distributed" that the amounts which would be charged to the intrastate business of the Chicago area of the Illinois Company are as follows:

1923	$203,459	1928	$57,446
1924	211,228	1929	22,390
1925	238,046	1930	19,844
1926	160,482	1931	45,895
1927	154,036		

(R. III, 2511, 2512.)

Now, the total costs to the American Company of the twelve departments were prorated on the basis of use and benefit (see Opinion of statutory court, R. III, 2509, and also testimony of Dr. Jewett, R. I, 629-632, 689-690, 729-730, 732; and Mr. Gherardi, R. I, 532, 533, 541, 544, 547).

Thus the table above shows the share of the total tax costs of the American Company which should be allocated to plaintiff if taxes are held to be "covered by the contract." Of course taxes are not *mentioned* in the license contract any more than office rent or stenographer's salaries.

However, plaintiff submits that any taxes which were incurred by the American Company in connection with the License Contract services should be a part of the License Contract costs and that the findings and statements of the court above referred to show that the taxes thrown out were of that kind and should have been included.

A brief reference to the record will make that plain beyond question.

The taxes paid by the American Company in each year covered by the suit which were claimed to be a part of the license contract costs were set forth in detail in Plaintiff's Exhibit A-161 (R. IV, 2993-2997). These taxes consisted of the following: *Instrument Tax (Illinois); New York Excise and New York Franchise Tax; Federal Capital Stock Tax; Federal Income Taxes.*

Considering the more important of these taxes very briefly:

(a) The Illinois Instrument Tax.

This was a property tax imposed by the State of Illinois upon all property within the state which of course included every telephone instrument in use in that state. The American Company owned the instruments (Record, I, p. 952). The License Contract agreement between plaintiff and the American Company required the American Company to pay this tax down to the year 1926,* and it did pay it (Record, I, p. 952).

All of this payment was for the benefit of the plaintiff alone and was a necessary cost of furnishing the instruments to plaintiff. Furnishing the instruments was an im-

* Contract changed with respect to payment of this tax at time of reduction of rate from 4½% to 4% (R. I, 952-953).

portant part of the License Contract in all years prior to 1928 when they were sold (Plaintiff's Exhibit 7, O.R. IV, 1198-1199, R. I, 949). The inclusion of the whole payment for Illinois instrument taxes does not seem to admit of any argument.

The amount of this tax was not in dispute and was set up and shown separately upon Plaintiff's Exhibit A-161, as follows (R. IV, 2933-2935):

1923	$41,651	1926	$1,540
1924	52,802	1927	60
1925	64,666		

(Chicago area.)

(b) Federal Income Taxes.

It is well settled that income taxes are a cost and should be deducted in determining profit, even in the case of a utility.

Galveston Electric Co. v. *Galveston*, 258 U. S. 388, 399;

Georgia Ry. v. *R. R. Comm.*, 262 U. S. 625, pp. 632-633.

Plaintiff showed income taxes paid under the License Contract allocable to the intrastate Chicago business of plaintiff, as follows (R. IV, 2933-2935):

1923	$110,303	1928	$28,669
1924	102,127	1929	8,732*
1925	111,559	1930	12,755*
1926	111,384	1931	7,102
1927	121,674		

* Red figures.

These amounts were obtained by a long and involved computation. It would require too much space to detail that here. Suffice it to say for the present that the *minimum* amount which was chargeable to the License Contract in each year was the corporation income tax upon the profit obtained under the contract in that year, as follows:

1923	12½%
1924	12½%
1925	13%
1926	13½%
1927	13½%
1928	12%

(c) New York State Excise and Franchise Taxes.

The American Company could not have carried on its business as a corporation and rendered the License Contract services to plaintiff and the twenty-three other operating companies which it served if it had had no corporate existence. It had to pay for the right to exist as a corporation. From the standpoint of the American Company a fair proportion of this tax was obviously a cost of furnishing services to the plaintiff under the License Contract. Likewise such fair share was a cost from the standpoint of the rate payers in Illinois. They cannot have it both ways. While it is true that if the plaintiff had performed the License Contract services for itself there would have been no New York franchise tax to deal with, on the other hand, the American Company, furnishing services to twenty-four operating companies, such as the plaintiff, at one time, does so at a much less cost than the Illinois Company could perform the work itself (O.R. III, 1045-1046, 1056). As the Illinois Company gets the benefit of the low

cost incident to mass production, it must stand its share of the small additional amount of taxes incident to the carrying on of the mass production business.

The plaintiff submits that under the strictest tests of what constitute License Contract expenses allocable to plaintiff's intrastate business, the above enumerated taxes qualify, accepting all of the determinations of primary facts made by the statutory court.

However, there is a broader basis upon which such taxes must most certainly be added to the costs found for all of the years 1923 to 1928 inclusive.

In all of those years, the court in finding the allowable deductions from income of the Illinois Company disregarded the actual payments made by the Illinois Company to the American Company and restricted such deduction to the fair share of certain costs which were incurred by the American Company in rendering the License Contract services to the twenty-four Licensee Companies, as shown in (1), *supra*, page 80.

If the License Contract is not to determine the deduction, then the fact that the service was not one specifically mentioned therein is a matter of no consequence. It is exactly as if there had never been any contract. In such case a service rendered or an expense incurred *dehors* the contract would stand on exactly the same footing as one specifically enumerated therein, provided that it was for the benefit of plaintiff or was incurred in connection with a service to plaintiff.

Plaintiff has already shown that the statutory court stated in its opinion that the American Company had incurred expenses for taxes and that "if such taxes were

distributed in accordance with the percentages on which the actual costs to the American Company of its twelve departments were distributed'' (that is, on the basis of benefit and use), that certain definite amounts found by the court should be allocated to the operating expenses of the intrastate business of the Chicago area of plaintiff (*supra*, p. 79) (R. III, 2511-2513).

Those amounts as found should be added to the costs of the American Company found in Finding 22, in determining the allowable deductions of plaintiff for the services of the American Company. This should apply to all years, but most certainly to the years 1923 to 1928 inclusive, when the License Contract was ignored and the deductions allowed were less than the amounts paid by plaintiff.

The addition of these taxes for the years 1923 to 1928 only would add to plaintiff's deductions from income found by the statutory court and deduct from its net revenues so found upwards of a million dollars (O. R. III, 2511-2512).

Plaintiff has not gone into the details of the increases in its deductions in each year which would result from the correction of the errors of the court shown in the above argument, nor of those shown in (1) above, because plaintiff considers that the argument in (3) immediately following is decisive of the whole question of plaintiff's deductions in all years, and that the above matters have their principal importance in supporting that argument.

(3) Upon the uncontradicted evidence and even upon the facts formally found by it, the statutory court should have sustained the license contract as fair and reasonable and all payments thereunder as proper deductions from revenue.

Upon the first trial, the statutory court made no formal findings of fact but stated the facts found by it carefully and fully in its opinion. With respect to the allowance of the payments made by the plaintiff to the American Company under the License Contract as proper deductions from revenue, the statutory court said:

> "The case for the allowance of the entire amount for services is a strong one. We have already found that the record does not show the abuse of the power of stock ownership which operates to destroy the corporate identity of plaintiff. * * * The test is the nature of the benefits received by plaintiff and whether or not it probably could have secured better terms elsewhere. Houston *v.* Southwestern Bell Telephone Co., *supra;* Missouri *ex rel.* S. W. Bell Telephone Co., *supra;* United Fuel Gas Co. *v.* Railroad Commission, *supra;* Indiana Bell Telephone Co. *v.* Public Service Commission, *supra;* Northwestern Bell Telephone Co. *v.* Spillman, 6 Fed. (2nd) 663" (Old Record, I, pp. 190-191).

The uncontradicted evidence upon the first trial fully supported the determinations of fact by the statutory court above referred to, and that record is a part of the record now before this court upon this appeal.

There was no complete new trial, nor any redetermination of the issues of fact raised upon the previous trial. Upon the second trial the only evidence introduced with

respect to the License Contract services was such as showed: (a) that the same kind and amount of License Contract services were continued in the years 1929, 1930, 1931 and 1932, (b) the cost to the American Company of furnishing such services in all years 1923 to 1931 inclusive, and (c) the fair proportionate share thereof which should be allocated to the operating expenses of the intrastate business of the plaintiff. The only new determinations by the statutory court with respect to the License Contract were set forth in its opinion on the second trial (R. III, 2509 to 2512), and the only formal findings made by it with respect to the License Contract were Findings 22, 23 and 25 (R. III, 2519, 2520). Nothing in the opinion of the statutory court upon the second trial shows any change of mind concerning the License Contract so far as any of the matters above quoted from its opinion upon the first trial are concerned.

Thus, it may fairly be said that all of the ultimate facts found with regard to the License Contract are as follows:

> That there was no abuse of power by the American Company of its stock ownership in plaintiff in order to obtain an unfair contract, and that the parties in making *and in continuing* the License Contract intended an agreement which would be fair to both parties, and further that the benefits received by plaintiff under the License Contract could not have been secured upon better terms elsewhere. (The evidence shows that they could not have been obtained elsewhere except upon much less advantageous terms) (O.R. II, 1045-1046, 1056; R. III, 2194).
>
> On the other hand, the Statutory Court found that in its actual operation the License Contract yielded a substantial profit to the American Company in six of the nine years in question, and a substantial loss in the

remaining three years (Findings 22 and 23, R. III, 2519-2520).

Further, that over the whole period of nine years the License Contract costs incurred by the American Company in connection with plaintiff's intrastate business in Chicago amounted to 84.4% of the amount which it received for those services. (All of the above facts stated are obtainable from Findings 22 and 23 alone, by comparing and adding figures therein R. III, 2519-2520.)

Thus, there was presented to the statutory court the question of how it should deal with the above facts, and whether the payments made under a contract of great value to plaintiff, intended to be fair and *sought to be kept fair** should be disregarded in computing the deductions from revenue of the plaintiff, merely because the American Company owned the control of the plaintiff and had expended in rendering services to the plaintiff 84.4% of the payments therefor and not 100%.

The statutory court answered the question in the affirmative and paid no attention to the License Contract whatever *except to restrict the deductions on account of the services of the American Company to the Illinois Company below the actual cost thereof* as shown in subdivisions (1) and (2) of this point (*supra*).

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* Rate of payments reduced constantly in face of continuous line of decisions of this and other courts sustaining the higher rates. 4½ per cent. sustained in 1922 (259 U. S. 318; 262 U. S. 276, 288; 1924, 300 Fed. 190, 204; 1925, 5 F. (2d) 77, 96). Reduced from 4½ per cent. to 4 per cent. in 1926 (Plaintiff's Exhibit 7, Old Record, IV, p. 1215). 4½% sustained in 1926 (12 Fed. 279, 285; affirmed 276 U. S. 97; 133 S. E. 144). Rate voluntarily reduced from 4 per cent. to 2 per cent. in 1927 (R. II, 1165). Again reduced from 2 per cent. to 1½ per cent. in 1928 (R. II, 1165).

The statutory court reached the above conclusion, which was the opposite of its conclusion upon the first trial because it construed the direction of this court quoted at p. 79, *supra*, as instructing it to (a) find the costs to the American Company of furnishing the license contract services, and (b) *measure* the allowable deductions from revenue of plaintiff in each year on account of the license contract services by the fair share allocable to plaintiff of such cost of the American Company in that year.

Plaintiff finds no such instruction as (b) above, either in the portion of the opinion of this court quoted at p. 79 (*supra*) or in the whole opinion and finds that any such direction would have been contrary to a long line of decisions of this and other courts.

In *United Fuel Gas Co.* v. *R. R. Commission*, 278 U. S. 300, 320, 321, this court stated the rule with respect to contracts between closely affiliated corporations as follows:

> "Common ownership is not of itself sufficient ground for disregarding such intracorporate agreements when it appears that although an affiliated corporation may be receiving the larger share of the profits, a regulated company is still receiving substantial benefits from the contract and probably could not have secured better terms elsewhere. (*Missouri ex rel. Bell Tel. Co.* v. *Public Service Commission*, 262 U. S. 276, 288; *Houston* v. *Southwestern Telephone Co.*, 259 U. S. 318.)"

The above decision, like those cited therein, related to public utilities, and the two telephone cases cited were cases where the very License Contract here in question was sustained under the rule above quoted. To the same general effect see the following:

Pacific Tel. & Tel. Co. v. *Whitcomb*, 12 F. (2d) 279, 285 (affd. 276 U. S. 97);

Northwestern Bell Telephone Company v. *Spillman*, 6 F. (2d) 663, 664;

Southern Bell Tel. & Tel. Company v. *Railroad Commission*, 5 F. (2d) 77, 96;

Indiana Bell Telephone Company v. *Public Service Commission*, 300 Fed. 190, 204;

New York Telephone Company v. *Prendergast*, 36 F. (2d) 54, 67;

State v. *Southwestern Bell Telephone Company*, 115 Kan. 236, 223 Pac. 771;

City of Detroit v. *Michigan, etc.*, 209 Mich. 395, 177 N. W. 306;

Cincinnati v. *Public Utilities Commissioners* (Ohio), 148 N. E. 817.

In the face of the above decisions that affiliated corporations may make *fair* contracts with each other, it does not seem possible that this court in deciding the former appeal in this case intended to lay down a rule that a dominant corporation can make no contract with one controlled by it unless the contract be *unfair*—unfair to the dominant corporation and without profit or advantage to it.

Rather, it would seem that all that was intended by this court was to adhere strictly to the rule laid down by it in *United Fuel Gas Co.* v. *R. R. Commission* (*supra*), where the court said, in addition to the matter quoted immediately above:

> "We need not labor the point that a public service corporation may not make a rate confiscatory by reducing its net earnings through the device of a

> contract unduly favoring a subsidiary or a corporation owned by its own stockholders."

Thus in that case this court prescribed two tests with respect to contracts between affiliated utility companies, *first*, the company receiving the service from its affiliate must get it as cheaply as it could secure the same service from an outsider, but *further*, the affiliate furnishing the service must not obtain *undue* profit.

Now in the case at bar, the statutory court, upon the first trial, applied only one of those tests and upheld the License Contract because it found that the services were important and even necessary to plaintiff and the price at which they were obtained from the American Company was less than that for which they could have been obtained elsewhere (O.R. I, 190-191).

This court was not satisfied with the application of that one test and directed the statutory court to find what profit the American Company was making and apply the other test. Thus this court, at page 157 of its opinion, directed the statutory court to find the cost to the American Company of the License Contract services,

> "And the reasonable amount which should be allocated in this respect to the operating expenses of the intrastate business of the Illinois Company in the years covered by the decree."

This is not a direction to restrict the allowable deductions of the Illinois Company for License Contract services received by it from the American Company to the precise amount represented by the cost to the American Company of furnishing those services.

This court's obvious intention was to direct the statutory court to use the costs incurred by the American Company as a *test*, and not as a *measure*—a test of the reasonableness of the payments to the American Company, not as a *measure* of the operating costs of plaintiff.

The above seems clear from the opinion of this court in *Smith* v. *Illinois Bell* alone, but it seems conclusive when that opinion is read in connection with its other decisions cited at page 93, *supra*.

However, the statutory court misinterpreted the directions of this court. It found the cost of the License Contract services to the American Company, but instead of using that as a test of the reasonableness of the payments, it made no finding as to reasonableness and, using the costs to the American Company as a measure, meted out to plaintiff as its full allowable deduction from revenue the exact share of the total costs to the American Company which it found was properly chargeable to the operating expenses of plaintiff's intrastate business in its Chicago area.

Plaintiff submits that upon the authorities and upon the findings of the Statutory Court in its Findings No. 22, No. 23 and No. 25 (R. III, 2519-2520), and without reference to anything else, the License Contract should have been sustained as fair, and all the actual payments made thereunder by plaintiff should have been held proper deductions from revenue.

(a) The difference between the payments for license contract services by plaintiff as found, and the cost of those services as found, does not indicate an unreasonable profit to the American Company, especially in view of the great advantage which the plaintiff received therefrom.

(b) The difference between payment for the services found in Finding No. 23 and the cost thereof found in Finding No. 22 is substantially greater than the true difference.

(c) No sufficient consideration was given to the patent rights of great value which were conferred by the license contract.

Considering (a) above:

As was shown by the evidence, it would have cost the plaintiff much more than it paid the American Company to have performed for itself only a part of the services which it was obtaining from the American Company (O.R. II, 1045-1046, 1056). The services of the American Company were unique. There is no organization in the world comparable to the scientific and research departments of the American Company. There was no source other than the American Company from which plaintiff could have obtained such services (R. III, 2193-2194). In the Bell Laboratories and on the general staff of the American Company there were employed in 1929 seven thousand people, over three thousand of whom were trained scientists and engineers (O.R. III, 996). Those organizations conducted research and development work in all branches of the telephone business and furnished advisory and consulting services to the Associate Companies of the Bell System (O.R. III, 970).

While the Illinois Bell is one of the large and important telephone companies of the country, it constituted only approximately 8% of the entire Bell System of operating companies. Obviously, neither it nor any of the operating companies could afford to employ the number and class of scientists and engineers who were employed by the Ameri-

can Company and whose work benefited alike all twenty-four companies of the System (O.R. III, 976).

The American Company was under no duty or obligation to the people of Illinois or to the people of any other State to carry on this work for them. The License Contract work of the American Company is entirely beyond and outside of that of the ordinary operating telephone company. The License Contract was in no sense a case where the work of furnishing one service has been split up between two companies so that there might be a duplication of profit.

Some idea of the extent of the business of the operating companies may be gained from the fact that during the time covered by the trial, there were over 300,000 employees (Defendants' Dep., Exh. 195, R. V, 3570, stamped by error 3670) and the number of calls handled was between twenty and twenty-five billion per annum (R. I, 530). This army of employees and enormous volume of business made efficiency a matter of prime importance and permitted the expenditure of vast sums to make small savings. Thus, for illustration, the saving of one-half second in the handling by one class of telephone operators ("A" Operators) of each simple local call would result in a saving annually of approximately five million dollars to the Bell System (R. I, 530). Therefore, it was reasonable to spend, and the American Company did spend, large sums to effect seemingly small economies which could be utilized throughout the system (R. I, 528-531).

These expenditures saved the plaintiff vast sums (O.R. III, 1044-1045).

In the circumstances, plaintiff submits that the American Company is entitled to a fair and substantial profit

upon the actual cost of performing the License Contract services, and that the difference between the cost of the service, and the payment therefor over the entire period 1923-1931, as found by the statutory court in its findings Nos. 22 and 23, R. III, 2519, was not unreasonable.

Considering (b) above:

The true difference between cost and payment was much less than that found by the court. As shown in (2), *supra*, pages 82 to 88, the court below erroneously omitted from the cost found by it all taxes and other elements of cost claimed by the plaintiff and *found by the court* but held not to be expressly covered by the License Contract.

Correcting for these errors alone would bring the costs up to more than 90% of the payment.

In addition to those errors shown right on the face of the court's opinion, it trimmed down at several points items of cost which it did include. This trimming was contrary to the evidence. For example, the American Company set up on its books depreciation on the telephone instruments which it furnished to plaintiff (R. I, 943-944). The statutory court properly held that depreciation on the instruments was an element of cost. The evidence introduced by plaintiff showed that 7% was reasonable and a minimum (Plaintiffs' Exh. A-163, R. IV, 2940; R. I, 922-923). There was no other evidence introduced. Yet, the statutory court without discussing the matter, takes 6% for depreciation (Opinion, R. III, 2510). The effect of this seemingly small difference was substantial as the 1% is applied annually to between two and three million dollars (Plaintiff's Exh. A-163, R. IV, 2940).

Again, the statutory court in finding the return on the telephone instruments finds it at 6% for all the years such

instruments were furnished by the American Company (Opinion, R. III, 2510). During all of these years the statutory court found that a fair return upon all of the other, telephone property of the plaintiff used in furnishing its service to its subscribers in Chicago was 7½% (Finding of Fact No. 32, R. III, 2521). The court states no reason, and there seems to be none, why the return on this part of the property required for plaintiff's telephone service should be at a substantially lower rate. Again, there is a difference of 1½% applied to between two and three million dollars annually (Plaintiff's Exh. A-163, R. IV, 2940).

There were other minor instances where the statutory court erroneously trimmed items of License Contract costs proven by plaintiff. The above are the most important, however, and those items, together with taxes, go far toward closing the gap between cost and payment, between 84.4% and 100%.

Considering (c) above:

No proper consideration and allowance was given to or for the patent rights of enormous value which plaintiff received under the License Contract. The American Company and its subsidiary, the Bell Laboratories, filed hundreds of patent applications and took out great numbers of patents each year. The American Company also purchased patents continually. In so far as the actual cost to the American Company in the years 1923-1931 of obtaining patents is concerned, the statutory court took that into account and made an allowance therefor in the figures of cost found by it in its Finding No. 22.

The patent cost to the American Company in those years was very small, comparatively, and the share thereof allocated to plaintiff was almost trifling. However pat-

ents acquired both subsequent to 1923 and prior thereto had great values and much in excess of the cost thereof to the American Company. Most of the patents in question were taken out by employees who were obligated to give any inventions made by them to the American Company without cost. Sometimes these inventors were presented with a nominal honorarium of $50 or $100 when the patent was one of great importance.

In the field of radio, which has many features kindred to that of telephony, the American Company exchanged rights under patents which had cost it little for rights to use in the telephone field, patents of the General Electric Co., Westinghouse Co. and other corporations, which rights were worth upwards of $10,000,000 (R. I, 651-652; R. II, 1169-1170; Plaintiff's Ex. A-198, E (b), R. V, 3240). These were passed on to the Associate Companies, including the plaintiff, without charge other than its regular license contract payments.

Any owner, including even a utility, has a right to a fair return upon the *fair value* of its patents or patent rights and is not limited to a return upon the actual cost. *Pacific Gas Co.* v. *San Francisco*, 265 U. S. 403, 406-416. Now the American Company did not under its license contract agreement agree to furnish its Associate Companies with rights under all of its patents at cost. What it did was to agree to furnish for 4½% of gross revenue a great number of miscellaneous services, the use of telephone instruments, and the use of patents.

The procuring of a body of over 9,000 patents was no part of the business of an operating telephone company, and in any event, and regardless of the close relations of the two companies, it would be proper for the American

Company to get some profit from its patents and some recognition of the difference between the cost and value thereof. This argument seems the stronger because of the fact that if the plaintiff had acquired these patents or rights thereunder for the nominal sums which the American Company expended it would still be entitled to a return on *value thereof,* and not the cost. *Pacific Gas Co.* v. *San Francisco, supra.*

Thus an allowance to the American Company on the value of its patents imposes no additional burden upon the Illinois telephone subscribers. On the other hand, if no recognition is taken of the value of these patents and no allowance made the American Company therefor, the telephone subscribers of Illinois will receive their service more cheaply because these patents were obtained by the American Company and rights thereunder conferred on the plaintiff, than if the plaintiff had obtained the patents itself at a nominal price.

To summarize: It is shown that the contract is a most valuable one to plaintiff and that it is receiving a necessary service for much less than it could obtain the same elsewhere. The service of the American Company is unique; there is nothing like it performed for any industry in the world and it is of great advantage to plaintiff's subscribers as well as to plaintiff.

The costs found by the court at 84.4% of the payments received therefor are shown to be substantially more than 90%—approximating 95%—of such payments when corrections are made for the obvious understatements of the statutory court. In addition to incurring those costs in the years in question, the American Company conferred valu-

able patent rights on plaintiff. The American Company was entitled to an allowance based on the *value* thereof and *not on bare cost.*

In view of the above facts, the license contract must be upheld and the payments thereunder allowed as fair unless this court is prepared to hold that the American Company can obtain no profit whatever from the plaintiff.

Such a holding would be directly contrary to the long line of decisions cited at p. 93, *supra,* and would require the American Company to furnish its license contract service in Chicago without profit when it is entitled to a reasonable profit for furnishing the same services in Cincinnati, solely because the American Company owns a great majority of the stock of plaintiff and owns only a minority interest in the Cincinnati Company.

3. The court erred in deducting from the plaintiff's reasonable operating expenses subsequent to November 1st, 1930, ten per cent of the prices charged by Western on purchases made by plaintiff attributable to maintenance and other expense accounts (assignments of error 9 and 13).

Finding 21 of the court reads as follows:

> "In determining reasonable operating expenses to be allowed to plaintiff after November 1, 1930, there should be a reduction of ten per cent from the prices charged by Western Electric Company on purchases made by plaintiff attributable to maintenance and other expense accounts and this deduction has been made in determining the amount allowed in these findings on account of plaintiff's operating expenses" (R. III, 2519).

The deductions made from operating expenses of plaintiff on this account were $67,167 for the last two months of 1930, $332,470 for 1931 and an equal amount for the year 1932.*

These reductions from plaintiff's necessary operating expenses were improperly made and resulted in overstating to the extent indicated the dollars available to appellant for a return on account of its intrastate operations in Chicago. The reasons why this reduction is improper were fully discussed at pages 36 to 44, *supra*, and need not be restated here.

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* The net purchases of plaintiff from Western for each year down to 1931 for its Chicago area property are shown by Exhibit X-400 (R. VIII, 4779, 4780). The per cent of such purchases attributable to maintenance and other expense accounts is shown on Exhibit A-61 (R. IV, 2783; R. II, 1265; R. I, 232). The court did not restrict this deduction of ten per cent. to telephone apparatus included in such purchases attributable to maintenance and other expense accounts, but applied the reduction to all such purchases.

III.

Fair Rate of Return.

The Court Below Erred in Finding that the Fair Rate of Return on the Fair Value of Plaintiff's Property Was Only 6½% for the Year 1931 and 5½% for 1932.

The court below found the fair rate of return as follows:

> "32. The fair rate of return on the average fair value of plaintiff's intrastate property was 7½% for each of the years 1923 to 1927, inclusive, 7% for each of the years 1928, 1929 and 1930, 6½% for 1931 and 5½% for 1932" (R. III, 2521).

Plaintiff took exception thereto in its Assignment of Error No. 21 (R. IV, 4968). In the above finding the fair rate of return allowed in a number of years is below what was shown proper by the evidence. However, except in 1931 and 1932 the error did not seriously harm plaintiff because of the smallness of the difference and because of the remoteness of the time. Plaintiff, therefore, has assigned error to the findings of the fair rate of return for the years 1931 and 1932 only.

The above finding No. 32 is the only reference made by the statutory court to the fair rate of return in its formal findings and the only finding which has any relation thereto.

In its opinion the statutory court quoted from the opinion of this court in the *Bluefield* case, and then stated:

> "We have given weight to the facts of which the court takes judicial notice relative to the general decline in corporate earnings during the years 1931 and 1932. It is for this reason that we have fixed 6½% as the proper rate of return for 1931 and 5½% as the proper rate of return for 1932" (Opinion, R. III, 2514).

The statutory court has fallen into error through a plain misinterpretation of the rules laid down by this court in the *Bluefield* case and reaffirmed repeatedly thereafter. In the *Bluefield* case this court said:

> "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." Bluefield *v.* Public Service Commission, 262 U. S. 679, 692, 693.

Plaintiff believes that no sound exception can be taken to the fairness, clearness and logic of the above statement. The statutory court, however, quoted the first few lines of the above, and *misinterpreting them*, assumed that the "general decline in corporate earnings during the years

1931 and 1932" (which the court took notice of) indicated that rates on investments in other business undertakings had decreased. The Court's error was that, while taking judicial notice of the general decline in corporate *earnings*, it failed to take judicial notice of the more notorious and greater decline in the *market prices of corporate securities*, and failed to take that fact into consideration and accord due and proper weight to it.

The undisputed testimony in the case is that it was harder to get money in 1931 and 1932 than in the years previous thereto, and that in those years capital could not be attracted into this business for a return under 8% (R. I, 160).

Of course, as business conditions grow worse, capital becomes more timid, the cost of money increases, and investors require a *greater rate* of return upon their funds before they will put them out at the hazard of business. This fact was recognized and well stated in the decision of the statutory court in the recent case of *Wichita Gas Co.* v. *Public Service Commission* 2 F. Supp. 792, 810. There a witness for the Commission had testified that 8% would not be an unreasonable return in normal times but that the present times were abnormal and that the rate should be less.

The court commenting upon this testimony said:

> "* * * *but if abnormality is considered, the return must be increased, not decreased.* In these times when the stock of the best utilities can be purchased on a 9% basis or better, certainly an 8% return on this hazardous enterprise is not unreasonable."

We do not conceive that "fair rate of return" is a matter of formula, any more than fair value is a matter of formula. But the settled law is not suspended because of a depression. To refuse at any time *to give consideration and accord due weight* to the *current* rate of return which investors demand as the price of their capital, as the statutory court did here, is error of law. In every utterance of this court upon the subject, the rule has been plainly laid down that the fair rate of return is a rate sufficient to attract capital to the enterprise on reasonable terms *at the time of the inquiry.* It needs no argument to show that plaintiff could not have obtained permanent new capital, *which would carry the risks of the business,* at 6½% in 1931, or at 6½%, to say nothing of 5½%, in 1932. Moreover, the uncontradicted testimony shows this.

It is to be borne in mind that the question is not what return plaintiff shall earn. The court could not guarantee to plaintiff any earnings or rate of earnings. The question is whether or not the company may be deprived of an opportunity to earn, if it can, a given rate of return; whether or not telephone rates may be imposed upon it by law which will deprive it of that opportunity.

Every utility must provide the means of obtaining *the whole* of the required investment; it must pay returns to cover the whole of the risks.

Returns to stockholders who carry the risks of the enterprise must obviously be higher than those to bondholders who occupy a preferred status and are protected by the stockholders' investment.

How to provide such a return to the stockholders, and in addition to set aside a margin for surplus, out of a return which has been forced down to 6½% is impossible for us to see.

An indication of the minimum return which the plaintiff must earn at all times is shown by the following:

Plaintiff floated a bond issue of $50,000,000 in 1923, thirty-year 5% first mortgage bonds upon its entire property in the State of Illinois (R. I. 1032). It has no other bonds outstanding. The cost to the company of these bonds over their entire life is 5.53% (R. VII, 4259a per annum). Obviously they are bonds of a very high grade. These bonds could not have been refloated at any better rate in 1931 and 1932; on the contrary, it would have been difficult to float them at all. Yet the statutory court has held that in 1931 plaintiff's right to earn upon the fair value of its property, an investment upon which the stockholders carry the entire risk and hazard (save only the almost negligible risk of the bondholders), is limited by law to a rate less than 1% in excess of the base cost to the plaintiff of a bond issue representing some 20% of the value of only the Chicago property.

In the *McCardle* case this court said:

> "Obviously the cost of money to finance the whole enterprise is not measured by interest rates plus brokerage on bonds floated for only a part of the investment." *McCardle* v. *Indianapolis Water Company*, 272 U. S. 400.

In the *United Railways* case the court said:

> "Sound business management requires that after paying all expenses of operating, setting aside the necessary sum for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account; and a rate of return which does not admit of that being

done is not sufficient to assure confidence in the financial soundness of the utility to maintain its credit and enable it to get the money necessary for the proper discharge of its public duties." *United Railways* v. *West*, 280 U. S. 234.

Clearly, when tested by this statement of the law, unless the depression has suspended the law, 6½% is substantially less than a fair rate of return in the years in question.

The rates allowed plaintiff by the statutory court in the years 1923 to 1930 inclusive are less than those which were shown proper by the evidence and less than many which have been sustained by this court in the case of important corporations,* some of them larger than plaintiff and conducting a less hazardous business (R. I. 157).

The only testimony in the record directly relating to the subject of fair rate of return was the testimony of plaintiff's witnesses Hoyt and Brown. These were both bankers, and probably two of the best qualified men in the country to speak on the subject. Hoyt had had 25 years of experience and had dealt in hundreds of millions of dollars of utility securities, sometimes representing the bankers purchasing, and sometimes the corporation itself (R. I. 151-2). He was a resident of New York and was familiar with all large financing throughout the United States.

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* 8% in *Consolidated Gas Co.* v. *Prendergast*, 6 F. (2d) 243, 280 (Affd. with modification, 272 U. S. 576).

8% in *Kings County Lighting Co.* v. *Prendergast*, 7 F. (2d) 192, 218 (Affd. with modification, 272 U. S. 579).

8% in *Brush Electric Co.* v. *Galveston*, 262 U. S. 443, 446.

8% in *Southwestern Bell Tel. Co.* v. *F. L. Smith*, 294 Fed. 102 (Affd. 270 U. S. 627).

8% in *Mobile Gas Co.* v. *Paterson*, 293 Fed. 208 (Affd. with modification, 271 U. S. 131).

7.44% in *United Ry. & Electric Co.* v. *West*, 280 U. S. 234.

Brown was a resident of Chicago and generally familiar with security prices and especially familiar with those dealt in in Chicago (R. II, 1153-4). The testimony of these two witnesses had high probative force, especially as there was no serious effort to break down or challenge their statements and no evidence was introduced to contradict it. Their testimony convincingly sustains a rate of 8% in the years 1931 and 1932 (R. I. 159-160, 213; R. II, 1153-4).

The City of Chicago called no bankers, dealers in securities, officers of corporations or other person to testify to any fair rate of return.

We submit that there is no possible justification for restricting plaintiff to a lower fair rate of return for the years 1931 and 1932 than for the years 1928, 1929 and 1930, which the court conservatively found to be 7 per cent.

Conclusion.

While plaintiff does not seek a reversal of the decree, which was in its favor and grants all the relief sought, it prays the correction of the errors herein urged, which have resulted in the substantial undervaluation of its property, the substantial understatement of its operating expenses and corresponding overstatement of its earnings, and the determination by the court of a fair rate of return for the years 1931 and 1932 substantially lower than that to which plaintiff is entitled.

Respectfully submitted,

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(A)	Commission's Allowance for Maintenance and Retirements (Exh. A-59) (B)	Actual Charges for Maintenance and Depreciation (Exh. A-59) (C)	Actual Charges for Maintenance and Retirements (Exh. A-59) (D)	Difference between Actual Charges for Maintenance and Depreciation over Commission's Allowance for Maintenance and Retirements (C)-(B) (Exh. A-59) (E)	Excess of Commission's Allowance for Maintenance and Retirements over Actual Charges for Maintenance and Retirements (B)-(D) (Exh. A-59) (F)	Gross Additions (Exh. A-57) (G)	Retirements (Exh. A-57) (H)	Net Additions (Exh. A-57) (I)
1923	$ 8,501,920	$ 10,491,767	$ 7,411,610	$ 1,989,847	$1,090,310	$ 18,435,639	$ 3,978,036	$ 14,457,603
1924	9,608,787	11,166,791	8,477,943	1,558,004	1,130,844	15,743,357	4,901,150	10,842,207
1925	10,761,514	12,406,222	8,809,061	1,644,708	1,952,453	21,442,182	5,936,341	15,505,841
1926	12,070,873	14,458,366	10,508,731	2,387,493	1,562,142	20,924,698	6,502,325	14,422,373
1927	13,350,988	16,261,731	11,904,371	2,910,743	1,446,617	22,467,008	7,629,612	14,837,396
1928	14,634,313	18,319,863	14,801,817	3,685,550	167,504*	25,177,797	10,682,043	14,495,754
1929	15,811,377	19,900,402	18,823,877	4,089,025	3,012,500*	27,124,452	14,715,881	12,408,571
1930	16,731,753	21,104,391	18,430,669	4,372,638	1,698,916*	20,884,218	12,255,613	8,628,605
1931	17,290,203	20,854,733	17,392,892	3,564,530	102,689*	17,108,257	12,972,309	4,135,948
Total 9 years	$118,761,728	$144,964,266	$116,560,971	$26,202,538	$2,200,757	$189,307,608	$79,573,310	$109,734,298
Round Figures	$119,000,000	$145,000,000	$117,000,000	$26,000,000	$2,200,000	$189,000,000	$79,000,000	$110,000,000

* Decrease.